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April 11, 2022

Ms. Vanessa A. Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Comment Letter of Federated Hermes, Inc. on the U.S. Securities and Exchange Commission's Proposed Amendment to Rule 2a-7 Requiring the Use of Swing Pricing in Institutional Prime and Tax-Exempt Money Market Funds (SEC File No. S7-22-21)

Dear Ladies and Gentlemen:

This letter¹ presents the comments of Federated Hermes, Inc. and its subsidiaries ("Federated Hermes" or "FHI") with respect to the recent issuance by the Securities and Exchange Commission (the "SEC" or the "Commission") of a release proposing reforms to Rule 2a-7 that require, among other things, that all non-government and retail money market funds (i.e. institutional prime and tax-exempt money market funds, "MMFs") use "swing pricing" in some circumstances and to create new requirements related thereto; the proposed amendments are collectively referred to herein as the "Release" or the "Proposal."² This letter will focus primarily on swing pricing as proposed. FHI has filed a separate comprehensive comment letter addressing other aspects of the Proposal.³ Federated Hermes is one of the largest investment management firms in the United States (the "U.S."), including \$301 billion in registered money market fund assets and a total of \$451 billion in cash management products as of December 31, 2021. With 106 domestic or international mutual funds and ETFs, and a variety of collective funds and separately managed account options, Federated Hermes managed \$669 billion in assets as of December 31, 2021 and provides comprehensive investment management to more than 8,400 institutions and intermediaries including corporations, government entities, insurance companies, foundations and endowments, banks and broker/dealers.

Federated Hermes has managed money market funds since their inception and remains a leader in the management and distribution of MMFs around the world. With over 45 years of experience in managing MMFs, we have witnessed firsthand their embodiment of the SEC's statutory mandate of capital formation, efficiency and competition. Our prime, tax-exempt and government MMFs have materially improved the yield to shareholders and reduced the borrowing costs for municipal and corporate issuers. Throughout this long history we have steadfastly defended MMFs against unwarranted arguments for bank-like regulation or other amendments that would scuttle prime and

¹ "Federated Hermes Comment Letter II"

² <https://www.sec.gov/rules/proposed/2021/ic-34441.pdf> Release No. IC-34441.

³ See Federated Hermes Comment Letter I, April 11, 2022.

tax-exempt funds, while supporting proposals to improve their resilience. We are at the precipice of another ill-conceived rulemaking. In this letter, Federated Hermes will demonstrate that the costs of the proposed swing pricing requirement for institutional prime and tax-exempt funds far outweigh the alleged benefits; and that the adoption of mandatory swing pricing, as proposed, would be arbitrary and capricious.

Executive Summary

Federated Hermes strongly opposes the swing pricing Proposal in its current form for the following reasons.

1. Swing pricing will fail to reduce systemic risk while creating other significant adverse consequences (Section I, pages 7 – 13)

- The Commission’s assertion that mandatory swing pricing will not induce first-mover behavior, but instead cause institutional investors to delay redemptions to avoid paying unknown “market impact costs”, is completely unsupported, counter-intuitive and contradicts all available evidence.
- Swing pricing is more likely to increase systemic risk in the financial system overall because it will trigger a preemptive run from the funds similar to the one that occurred just prior to the effective date of the 2014 reforms.⁴ And as a result, more short-term paper will be directly owned, or owned through less regulated vehicles, without professional management that above all seeks to transact in fund securities in a manner to protect shareholders and the relative stability of fund NAVs.
- Swing pricing will inevitably lead to efforts to market time or game trading in a manner that would harm investors and the integrity of money market funds generally. This will be based, among other things, on the heavy redemption volumes that occur and can be gleaned from publicly available data, for example, at month and quarter ends or tax payment dates.
- Swing pricing will create what is arguably a new class of material non-public information (“MNPI”, specifically, the intent to redeem). There will be significant compliance cost across the industry to identify and protect this information from abuse by market timers.
- Swing pricing could improperly enrich some investors at the expense of others.
- Swing pricing will lead to increased volatility in fund performance and unnecessary randomness in both reported performance and in realized gains and/or losses for investors who seek these funds for safety of principal.

⁴ October, 2016.

- The above-referenced gains or losses may be subject to capital gain taxation that entails more onerous record-keeping and reporting than are required today.
- The Commission's proposed requirement that MMFs may base swing procedures on information developed from good faith estimates is impractical, will not work in stressed markets or in the required time frames to value fund shares for purchases and redemptions, and provides an entirely inadequate standard for fund valuation practices.
- Swing pricing could jeopardize the ability to designate institutional prime and tax-exempt MMFs as Cash and Equivalents.
- Swing pricing will further reduce or eliminate the use of the impacted funds as cash sweep vehicles.
- Swing pricing will reduce the viability of the funds overall and investors will seek alternative investments for their cash.

2. Swing pricing as proposed is deeply flawed and investors will be harmed, not protected by its implementation (Section II, pages 13 – 18)

- The swing pricing proposal fails to reflect that, through KYC liquidity requirements established under Rule 2a-7 and implemented with practices developed over many years, MMFs build liquidity ahead of anticipated large redemptions and do not incur a “market impact cost” when funding redemptions.
- In the event of large unanticipated redemptions, advisers fund redemptions primarily out of daily and weekly liquidity and do not incur “market impact costs”.⁵ Then in the ensuing several days, the portfolio is rebalanced to target maturity structure. In this process, the fund never incurs to cost of selling a “vertical slice” in the “pricing period” or in “current market conditions”. Furthermore, large unanticipated redemptions are likely to be accompanied by market events that would imply new adjustments to portfolio holdings or maturity structure. Thus, a vertical slice is in concept a flawed baseline assumption for what the adviser would actually trade. The imposition of the proposed mandatory swing pricing in these circumstances is unfair to redeeming shareholders and penalizes them in an arbitrary manner.
- The argument for swing pricing relies on an implied supposition that fund NAVs show a systematic decline over time that results from large redemptions. This effect is not observed in practice.

⁵ This is demonstrable subsequent to the implementation of the 2014 reforms to rule 2a-7. This process will be materially enhanced by the elimination of the link between weekly liquid assets and mandatory board action.

- Swing pricing will not work or protect investors or the short-term markets from events such as March 2020. In that case, markets froze. Relatively few market transactions took place and “good faith” estimates of what market impact would have been are meaningless.
- The swing pricing proposal fails to take into account other requirements of the release. In particular, and in light of the above observations, the elimination of the link between board action and weekly liquid assets, and any increase in required daily and weekly liquidity, eliminate the need for further reforms.
- Swing pricing in MMFs is in reality a wholly untested theory that would create a disastrous result – truly a solution in search of a problem.⁶

3. The operational challenges posed by swing pricing are onerous (Section III, pages 18 – 20)

- Funds that employ swing pricing cannot be used by many intermediaries that transmit trade information via the NSCC. A large portion of such trades are received by fund advisors much too late and are too volatile to enable a “good faith” estimate of a total net redemption amount and the associated market impact for calculating a swing factor. Significant and costly infrastructure changes would be required. These are unlikely to be undertaken by the industry, just as they were not undertaken to support swing pricing after Rule 22c-1 was promulgated.
- Multi-strike funds will require complex adjustments to daily operations. These will entail significant changes in the accounting practices for funds, the times that NAVs can be struck and the times that wires for same day settlement can be sent. There is substantial doubt that vendors to funds will be willing to undertake these changes on behalf of the relatively small number of affected funds; or that investors will accept potentially significant delays in receiving redemption proceeds.
- In seeking to prevent material dilution to remaining shareholders, the calculation of “market impact costs” is highly problematic and unrealistic in stressed market conditions. Reasonable estimates may be possible for large redemptions in normal markets; but even aside from its logical flaws, the causes and the effects of market turbulence make the estimation of market impact resulting from transacting a “vertical slice” of the portfolio during the “pricing period” under “current market conditions”, completely unrealistic.

⁶ Also see Comment Letter of European Fund and Asset Management Association (EFAMA) (March 23, 2022), available at: <https://www.sec.gov/comments/s7-22-21/s72221-20121032-273211.pdf> [sec.gov].

4. The SEC's statutory mandate should not be undermined by the systemic risk objectives of FSOC (Section IV, pages 20 – 21, and Appendix A)

- FSOC fails to acknowledge the basic economic fact that significant adjustments in market prices resulting from economic shocks are primarily due to new information being priced in; and secondarily from the purchases or sales that underpin the discovery process. This is established theory supported by extensive empirical data.⁷
- Yet FSOC and the Fed continue to base the argument for further regulation of open-end mutual funds and MMFs on the premise that selling in the face of new information is what causes price declines. The allegations are so distorted as to lay significant blame for the turbulence during March of 2020 on open-end fund and MMF sales. The SEC should not succumb to this false narrative.
- The Office of Financial Research 2020 Annual Report contradicts FSOC's arguments and points out that the markets were reacting to a pandemic and a shutdown of the global economy.
- Banking regulators should fix the liquidity problems in the short-term funding markets that were made worse by a mix of government inaction and excessive regulation that choked off market-making and froze out pools of liquidity from those markets.
- There are numerous actions that banking regulators can take to mitigate the adverse impact of banking reforms that destroyed liquidity in stressed markets
- The SEC should not deviate from its statutory mandate of promoting capital formation, market efficiency and competition because the Fed will not fix its own problems; or finds it inconvenient to fulfil its own lender of last resort mandate in crisis conditions that was the primary motivation for the adoption of the Federal Reserve Act ("FRA").⁸

5. Cost/benefit assessment demonstrates that swing pricing is a significant net negative and the Release itself is defective as it fails to fully state the cost/benefit criteria being

⁷ See for instance, Efficient Capital Markets: A Review of Theory and Empirical Work, Eugene F. Fama, The Journal Vol. 25, No. 2, Papers and Proceedings of the Twenty-Eighth Annual Meeting of the American Finance Association New York, N.Y. December, 28-30, 1969 (May, 1970), pp. 383-417, <https://doi.org/10.2307/2325486>

⁸ The FRA was framed in aftermath of the panics of 1893 and 1907. The Senator Robert Owen, who was a principal author of the FRA, provides a detailed account of the motivation for its adoption: "It should always be kept in mind that ... the main object to be attained ... is the *prevention* of panic [emphasis added], the protection of our commerce, the stability of business conditions, and the maintenance in active operation of the productive energies of the nation which is the question of vital importance." Thus, the "Lender of Last Resort" power given to the Fed was expected to be proactively employed in exactly the conditions such as were experienced in March 2020. See https://fraser.stlouisfed.org/files/docs/publications/books/fra_owen_1919.pdf at 43 - 44.

employed or appropriately state the related request for public comment. (Section V, pages 21 – 25)

- Swing pricing will not reduce first-mover behavior or systemic risk, and it is more likely to increase systemic risk.
- Swing pricing does not improve investor protection by reducing dilution to remaining shareholders. In particular, the alleged need for swing pricing implies that there is a systematic decline in fund NAVs due to large redemptions, which is not seen in practice. But it will severely reduce the utility of these funds and represent a material departure from the SEC’s mission.
- Swing pricing will be expensive to implement, if the industry is even willing to invest to make the required changes; and introduces numerous additional problems of market timing, unjust enrichment, tax accounting and recordkeeping, new MNPI, and other factors mentioned above.
- Implementing swing pricing as proposed would represent a failure to adequately consider less onerous alternatives, such as discretionary a liquidity fee, and a failure to adequately demonstrate actual benefits to investor protection (instead relying on the Commission’s conjectures).
- The Release fails to fully identify the cost/benefit criteria it intends to employ and therefore fails to appropriately seek meaningful, fully informed public comment.
- The proposed swing pricing provides no demonstrable benefits, but significant operational costs and harm to investors. Along with the numerous procedural errors, and the glaring fact that swing pricing would not have prevented the March 2020 crisis or eliminated the need for official sector intervention, it would, therefore, likely be found to be arbitrary and capricious.⁹

6. Federated Hermes Recommendations (Section VI, pages 25 – 31)

- The Commission should abandon its swing pricing proposal, and eliminate the link between 30% WLA and mandatory board action as proposed.
- Discretionary liquidity fees are preferable to swing pricing. (Mandatory liquidity fees, as contemplated by some commenters, would have the effect of triggering

⁹ 5 U.S.C. § 706(2)(A) (2018) (requiring courts to set aside agency action found to be arbitrary or capricious); *Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (holding that “an agency rule would be arbitrary and capricious if the agency has . . . entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise”).

preemptive redemptions in stressed markets as investors will try to ascertain the criteria from publicly available data.)

- The functional equivalent of discretionary liquidity fees is already allowed by rule 22c-2.
- Discretionary liquidity fees are also preferable to mandatory liquidity fees because they preserve the role and responsibility of the board to act to prevent material dilution or other unfair results for all shareholders based on actual circumstances.
- The SEC should not be ensnared in a redirection or usurpation of its defined mission toward goals that cannot be reconciled with its statutory mandate.
- Congress should require that banking regulators fix the problems created by the array of post-financial crisis reforms that materially impaired market-making, particularly in stressed market conditions.
- Even with further banking reforms, the SEC can take additional steps to improve liquidity in the short-term markets.

* * * * *

I. Swing pricing will fail to reduce systemic risk while creating other significant adverse consequences

a. Swing pricing will not reduce systemic risk

Swing pricing will not have a beneficial impact on systemic risk or stability and will introduce a different form of first-mover advantage. The linking of board action and WLA introduced in the 2014 MMF reforms has been a painful lesson in how shareholders anticipate the risk of any form of fee or gate. Remarkably, the Release comes to a startling new revelation that is unsupported, unsupportable and sheer speculation.

We do not agree that, as some commenters suggested, a swing pricing requirement would encourage investors to preemptively redeem and seek a first-mover advantage. Investors do not necessarily know whether the fund's flows during any given pricing period will trigger swing pricing or, if so, the size of the swing factor for that period. In addition, redeeming investors would bear the cost of liquidity under the proposed rule even when net redemptions are small, meaning that there would not be a clear advantage to redeeming earlier versus later.¹⁰

Experience demonstrated that any risk of a programmatic fee or gate will induce first-mover behaviour. Even the requirement that fund board must consider taking some action when weekly liquid assets ("WLA") touched 30% was sufficient to instigate run-like behaviour. Investors will preemptively run, as they did prior to the compliance date of the 2014 reforms; or deliberately

¹⁰ Release at 58.

circumvent the Know-Your-Customer (“KYC”) liquidity practices that have carefully developed by fund advisers by causing investors to redeem in a manner designed to be less predictable; or find still other ways to circumvent any sort of fee or gate. This will erode the market stabilizing effect of KYC-based liquidity practices and will exacerbate redemptions in stressed markets.

Remarkably, the Release explains that the Commission had previously excluded MMFs from consideration of swing pricing in the adoption of Rule 22c-1 because MMFs had other liquidity management tools – fees and gates – that would be sufficient to prevent redemptions from causing unfair dilution for remaining shareholders.¹¹ With the lessons learned from March 2020, and discretionary fees and gates removed by the proposed amendments to rule 2a-7, that basis for excluding swing pricing was, in effect, eliminated. However, the Commission goes on to explain that it: (i) considered a mandatory liquidity fee in lieu of swing pricing (and has sought comment if this is preferable); (ii) retains the de facto liquidity fee available to MMFs under Rule 22c-2¹²; (iii) but on balance determined that swing pricing was preferred.¹³ The Release offers this tortured reasoning rather than provide a clear framework to demonstrate why the proposed mandatory swing pricing, with unlimited potential “market impact costs”, will prevent first-mover behavior. Instead, it states:

This requirement is designed to ensure that the costs stemming from net redemptions are fairly allocated and do not give rise to a first-mover advantage or dilution under either normal or stressed market conditions.¹⁴

A mandatory swing pricing regime for net redemptions is intended to address funds’ (or fund boards’) likely reluctance to impose a voluntary swing pricing regime or voluntary liquidity fee.¹⁵

One is left to wonder why a fund board implementing a discretionary liquidity fee under current Rule 2a-7 would instigate preemptive runs while a mandatory fee in the form of swing pricing would not. In further defiance of reason, the Release goes on to state:

Rather than encourage preemptive redemptions, we believe the proposed swing pricing requirement would discourage excessive redemptions, particularly in times of stress, by requiring redeeming investors to bear liquidity costs. For example, investors may determine not to redeem during stress periods, or to redeem smaller amounts over a longer period of time, which could help reduce concentrated redemptions and associated liquidity pressures that institutional funds can face in times of stress.¹⁶

These assessments contradict the available evidence on investor behavior, particularly during the “dash for cash” during March 2020; and implies a deeply flawed perception that institutional investors – who require same day liquidity in MMFs – would somehow abandon their intended motivation for owning MMFs and essentially view them as fungible with time deposits during

¹¹ Release at 59.

¹² Release at 39. Also see Section VI.c of this letter.

¹³ Release at 60.

¹⁴ Release at 44.

¹⁵ Release at 47.

¹⁶ Release at 58.

stressed or crisis conditions.¹⁷ Thus, the premise of the Commission's proposal for mandatory swing pricing is counterfactual and contradicts the available evidence regarding investor behavior.

b. Swing pricing is more likely to increase systemic risk in the financial system overall

Institutional investors exited prime and tax-exempt funds after the 2014 reforms, which reduced the utility of institutional prime and tax-exempt funds, and current investors will do so if the Proposal is implemented.¹⁸ Investors who exited post the 2014 reforms typically moved to lower yielding vehicles (thus harming those investors while reducing market efficiency); or in many instances increased their direct holdings of short-term paper. Such direct holdings are not subject to daily and weekly liquid asset requirements and are subject to immediate sale (i.e. they are first-movers) in market turmoil such as we experienced in March 2020. As of June 2020, these investors represented a larger ownership of CP than prime MMFs, are not easily identified when they sell, and now have a larger impact in stressed market conditions than institutional MMFs.¹⁹

The Commission and particularly the Fed and FSOC have failed to account for the impact of these sales and incorrectly attributed the observed market turbulence to MMFs.²⁰ By March 2020 MMFs owned just 22 percent of commercial paper (CP) outstanding after the dramatic decline following the 2016 implementation of the 2014 MMF reforms.²¹ At the same time, direct holdings of CP by nonfinancial corporations approximately doubled from 2016 to 2020.²² This reflects investors moving their money into less regulated and less transparent accounts. Thus, the 2014 MMF reforms put more short-term paper into unregulated accounts that are more likely to engage in fire sales.²³ The proposed reforms will worsen market turbulence in stress periods even more for the same reason.

c. Swing pricing will inevitably lead to efforts to market time or game trading in a manner that would harm investors and the integrity of money market funds generally

It is well known to investors that large redemptions occur around tax payment dates or month and quarter ends, among other times. These create immediate arbitrage opportunities for sophisticated investors. By knowing the fund size, the 4% threshold and seasonal redemption patterns, arbitrageurs can easily determine how to profit from the pricing anomalies that swing pricing will necessarily create. The expected magnitude of arbitrage opportunities will be easily identified by fluctuations in the fund's published NAV in periods of larger redemptions. The form of swing

¹⁷ See Figure 3 in Appendix A for evidence that time deposits shrank significantly during March 2020.

¹⁸ Investment in prime and tax-exempt funds declined by over \$1 trillion leading up to the effective date of the 2014 reforms. See <https://www.sec.gov/files/primer-money-market-funds-commercial-paper-market.pdf> at 2.

¹⁹ <https://www.sec.gov/files/primer-money-market-funds-commercial-paper-market.pdf>

²⁰ <https://home.treasury.gov/news/press-releases/jy0587>

²¹ <https://www.sec.gov/files/primer-money-market-funds-commercial-paper-market.pdf> at 2-3.

²² <https://www.sec.gov/files/primer-money-market-funds-commercial-paper-market.pdf>

²³ The SEC discusses this issue, although the lack of detailed holdings data prevents a numerical evaluation compared with MMFs and other short-term regulated vehicles such as Ultrashort funds. See <https://www.sec.gov/files/primer-money-market-funds-commercial-paper-market.pdf> at 2.

pricing required by the Release, partial swing pricing, will have the adverse effect of creating a first-mover advantage by encouraging shareholders to redeem ahead of the others in the hope of avoiding the swing factor.

d. Swing pricing will create, and increase focus on, a new class of material non-public information (“MNPI”, specifically, the intent to redeem)

Under the proposed rule, investors will have an incentive to know the redemption plans of other investors. Institutions and intermediaries do not currently have the systems, policies or procedures to protect this information within their own organization or across firms, financial advisers, registered investment advisers or other MMF investors. The cost of new protection regimes, including compliance monitoring across every applicable firm, will be significant and have not been contemplated by the Release. Even worse outcomes can be anticipated: large redemptions that are made with the intent of manipulating fund prices. One such scenario could be an unscrupulous adviser who initiates a significant redemption for a large investor; and simultaneously enters subscriptions at an advantageous price for the benefit of a group of smaller clients. In such an instance, the adviser may stand to gain further business from the other clients based on a purported investing skill. Smaller MMFs will be particularly impacted by this effect.

e. Swing pricing could improperly enrich some investors at the expense of others

f. Shareholders who subscribe on days when price is swung down will receive a windfall profit. Contrasted with the diligent adherence to fair and accurate treatment of pricing and income, this will undermine the belief in the fairness of the institutional prime and tax-exempt funds

g. Swing pricing will lead to increased volatility in fund performance and unnecessary randomness in both reported performance and in realized gains and/or losses for individual investors

This is contrary to value proposition of products sought for safety of principal. It will materially undermine the value proposition that the SEC and fund advisors have worked to develop over the long history of these fund vehicles. In its 2016 explanation for why swing pricing was not appropriate for MMFs, the SEC also observed that:

money market fund investors (particularly, investors in stable-NAV money market funds) are particularly sensitive to price volatility ²⁴

h. The above-referenced gains or losses may be subject to adverse capital gain taxation

The IRS has not yet determined how such gains and losses will be taxed. Although the IRS determined that price fluctuations resulting from a floating NAV would be subject to simplified

²⁴ <https://www.sec.gov/rules/final/2016/33-10234.pdf> at 25. Thus, the Commission understands that investors in FNAV funds are also “particularly sensitive” to price volatility.

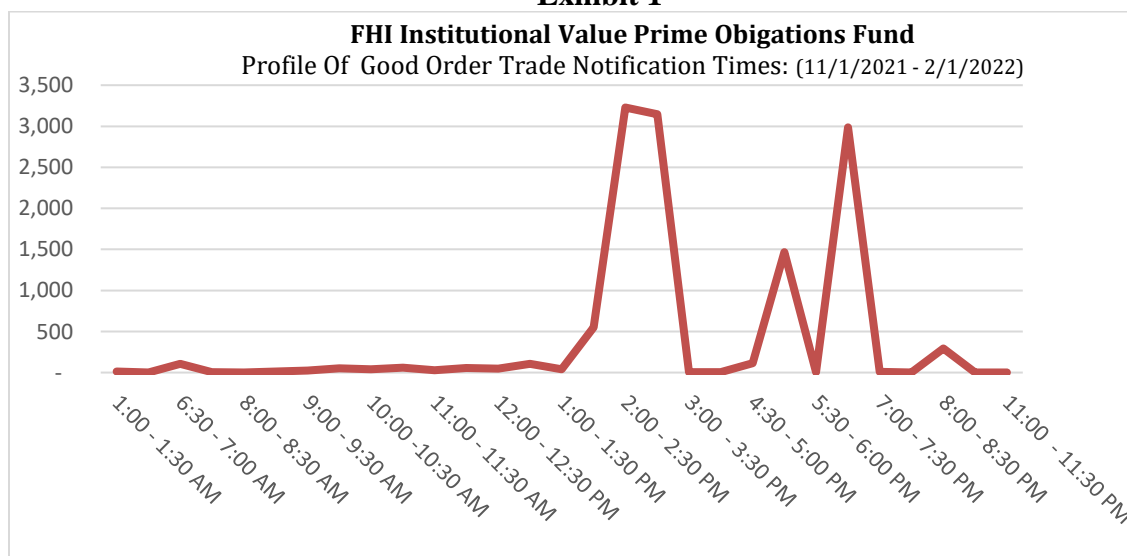
reporting, the record-keeping requirements remained.²⁵ The IRS has not yet taken a position on swing pricing. The Commission acknowledges that the IRS may not make a favorable determination:

We recognize that if the proposed swing pricing requirement modifies the method of accounting for gains or losses in relevant money market fund shares, or has other tax implications, the tax reporting effects of the proposed swing pricing requirement could increase burdens for investors.²⁶

i. The Commission’s proposed requirement that funds may base swing procedures on information developed from good faith estimates is problematic, will not work in stressed market conditions and provides an inadequate standard for fund valuation practices

The “good faith” standard for determining a “market impact cost” is ambiguous in its meaning and will likely differ from one fund complex to another. “Good faith” contrasts with the “reasonable high confidence estimate” standard of amended Rule 22c-1, with “good faith” potentially representing a lower standard.²⁷ Both Rule 22c-1 and the Release contemplate that advisers base swing factors on incomplete information regarding flows. To illustrate this problem, Exhibit 1 shows the average distribution of trade notification times over the day for FHI’s Institutional Prime Value Obligations fund. The data covers the representative period 11/1/2021 to 2/1/2022. Over this period, 35.7% of trade notices arrived after 3:00 pm and generally settle T+1. However, in these instances, the intermediary, acting as agent for the fund, warrants that the trades were in good order, meaning that they were received by the intermediary before 3:00 pm, and are therefore required to be priced using the T+0 NAV.²⁸

Exhibit 1



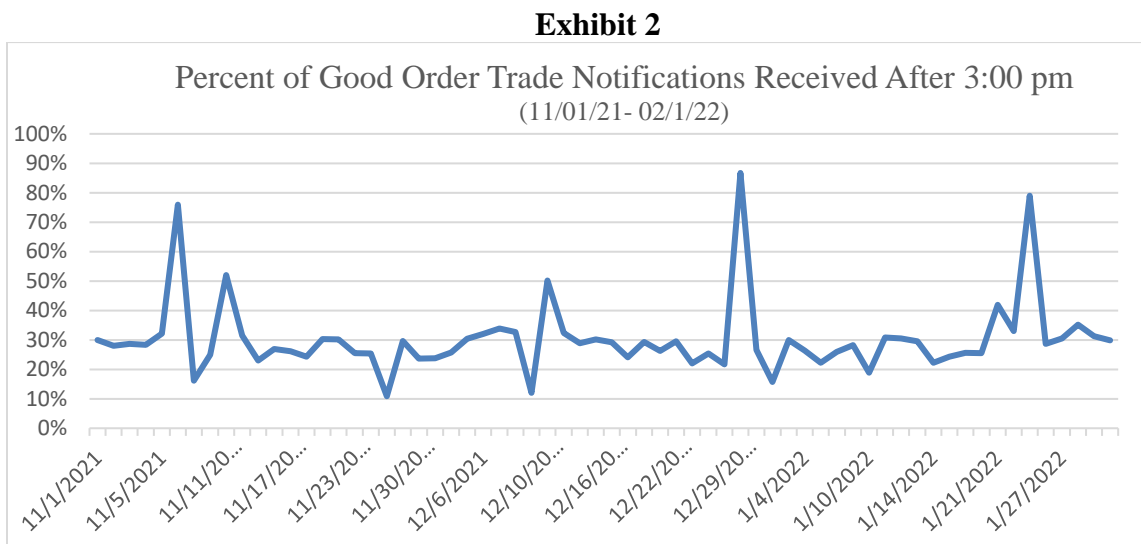
²⁵ The IRS determined that gains and losses could be aggregated over time and not individually reported.

²⁶ Release at 80.

²⁷ <https://www.sec.gov/rules/final/2016/33-10234.pdf> at 54,55.

²⁸ 3:00 pm is the time after which new trades in this fund are not in good order and do not receive T+0 pricing.

Exhibit 2 shows the variation in the percentage of good order trade notices received after 3:00 pm over time. Given this degree of uncertainty, FHI believes that it would be reckless to develop a “good faith” estimate of total flows, and whether or not net redemptions equal or exceed 4% of fund assets, based on data known by the adviser as of 3:00 pm.



Similarly, estimating the market impact of trading a vertical slice of the portfolio during potentially stressed markets (“current market conditions”), and during a precise window of time (the “pricing period”) would be exceedingly difficult. The events of March 2020 suggest that the greatest redemptions may occur when such conditions are prevalent. It may be possible to develop a schedule, by asset type, of estimated “market impact costs” for larger trade sizes under normal market conditions. However, in stressed or chaotic markets, normal condition estimates could be grossly misleading. For these reasons, we believe that relying on good faith estimates would create an undue risk of significant pricing errors. If this degree of imprecision was practiced by an adviser for an entire fund in other valuation circumstances, the adviser would likely be subject to an enforcement action. Advisers would therefore require a broad safe harbor to be protected against shareholder or SEC litigation based on 20 – 20 hindsight. It is also instructive to recall the Commission’s reasoning for not requiring an estimated “market impact cost” in allowing fluctuating funds to optionally adopt swing pricing in Rule 22c-1.

In light of concerns that many funds may not be able to readily estimate market impact costs, as well as concerns that subjective estimates of market impact costs could grant excessive discretion in the determination of a swing factor, we have eliminated the consideration of market impact costs in setting the swing factor under the final rule. In making this determination, we have balanced our concerns regarding potential abusive practices against the fact that funds using swing pricing potentially may not capture all the costs that are likely to result from shareholder transactions on the trade date.²⁹

²⁹ <https://www.sec.gov/rules/final/2016/33-10234.pdf> at 75.

j. Swing pricing will jeopardize the ability to designate institutional prime and tax-exempt MMFs as Cash and Equivalents

The Release suggests that under normal circumstances, MMFs subject to swing pricing could continue to be deemed Cash and Equivalents for balance sheet disclosure; but under conditions of credit or liquidity impairment, any asset deemed a cash or equivalent may require redesignation, and this would apply to MMFs with swing pricing as well.³⁰ However, there can be exceptionally large redemptions that predictably occur, for instance, on corporate tax payment dates or quarter ends. Moreover, the “market impact cost” is unlimited in magnitude under the proposed rule. In these cases, applying the proposed swing pricing methodology could lead to material price adjustments that would be comparable to adverse credit or liquidity events. Therefore, the proposed swing pricing rule is far more likely to require redesignation for balance sheet disclosure. Moreover, even if corporations did not redesignate, investors may call a Cash and Equivalent designation into question. Therefore, the above-referenced summary of the issue provided by the Release is potentially false and misleading.³¹

k. Swing pricing will likely eliminate the use of the impacted funds as cash sweep vehicles and reduce the demand for these funds generally

In paragraph I.i we clarified that funds, for which a significant percentage of redemption notices of good order trades are received by the adviser after the time at which NAV must be struck, cannot provide T+0 pricing for those trades with swing pricing. Consequently, insofar as good order sweep trades are typically received after the NAV is struck, they must be priced at T+1. This will make these funds impossible to use as sweep vehicles. Similarly, aside from sweep processes, investors who will now receive T+1 pricing for their trades will likely seek MMFs that are not subject to swing pricing. Thus, the utility of these funds for investors will be diminished.

II. Swing pricing as proposed is deeply flawed and investors will be damaged, not protected by its implementation

a. If a fund is already using bid pricing, the additional transaction costs to be applied in the event that net redemptions are between 0% and 4% are de minimis and will not impact the fund NAV, but will incur substantial costs and other drawbacks

i. Per transaction fees are negligible for a typical institutional trade

If a vertical slice of an institutional prime fund were transacted, the per transaction cost would be negligible. We estimate that the aggregate of per transaction costs for Federated Hermes Institutional Prime Obligations Fund would be \$1,500 for a vertical slice of the fund. In fact, the fund typically trades \$2 – 4 billion per day using a rough average of 25 individual trades per day.

³⁰ Release at 80-81.

³¹ Furthermore, although the fund itself remains a Level 1 asset for the investor, the entire portfolio becomes subject to the market impact price adjustment that, under the proposal, is subject to “good faith” estimates. Therefore, the portfolio itself is fair-valued every day and would be deemed a Level 2 asset of the fund.

\$1,500 on a base of \$2 billion represents .00000075 of fund assets, or .000075 of 1 basis point. Moreover, the assumption of a transaction in every security held by the fund is a flawed construct as any rational rebalancing would entail trades in a relatively small fraction of the securities held.³²

ii. Funds using bid pricing should not be required to impose swing pricing when net redemptions are between 0% and 4% of fund assets³³

There is no evidence whatsoever that the failure to recoup per transaction costs impair fund NAVs. As the collection of this de minimis amount entails costly administrative and systems modification fees, with no observable benefit to fund shareholders, for this and other reasons, the Commission should eliminate the swing pricing requirement for funds using bid pricing.

b. The “market impact costs” when net redemptions equal or exceed 4% are not observed as a systematic decline in fund NAVs, thus rendering the proposed rule a solution to a purely theoretical problem without a real-world counterpart

i. Swing pricing as proposed is deeply flawed and investors will be damaged, not protected by its implementation

The Commission’s premise for applying swing pricing – to prevent non-redeeming investor dilution caused by portfolio transactions costs driven by redemptions – is false. When large redemptions occur, the Advisor has usually already built daily liquidity in anticipation based on the KYC process and the knowledge of seasonal patterns in redemptions. Table A (p. 33) illustrates that for Federated Hermes Institutional Prime Obligations Fund (the “Fund”), a representative institution prime fund, since Q1 2017 there were 17 occurrences of net redemptions exceeding 4% out of 1,198 days, or 1.42%. The table illustrates that on those days, daily liquid assets (“DLA”) remained stable compared with levels prior to the redemption; or returned to that level immediately after the redemption.³⁴ This stability reflects the success of KYC discipline and liquidity management within the fund to anticipate redemptions. Similar findings apply to Federated Hermes Institutional Tax-Free Trust. This fund is designed to have 99+ % weekly liquidity using variable rate demand notes and a NAV that has not deviated from \$1.000.³⁵ Applying swing pricing as proposed by the Release to this and similar funds would add cost and complexity with no expectation of improved investor outcomes.

ii. The Swing pricing proposal fails to reflect a basic understanding of how MMFs are professionally managed

³² In a typical institutional prime fund, FHI may make an average of 25 trades per day. This implies \$125 in transaction costs, not \$1,500. Furthermore, seeking to collect fees in this manner is contrary to the basic construct of a mutual fund, in which the net return experience is “mutualized”.

³³ This comment letter provides overwhelming evidence that swing pricing should not be implemented at all.

³⁴ The liquidity management process is in part reflected in the maturity structure of weekly liquid assets; so if redemptions draw down daily liquidity, the next day it is restored by newly maturing securities.

³⁵ Except in the highly unlikely event of a credit loss, which has not been experienced over the life of the fund.

The Commission's premise is further flawed by the following: in cases where there are large redemptions that are not anticipated, they are normally funded out of daily or weekly liquid assets – and then soon after, longer dated assets are sold in a manner to not incur “market impact costs”. Such events are potentially illustrated by net redemptions ($> 4\%$) on Table A (p. 33) where there are 7 occasions that daily liquid assets declined on the day of the redemption in rough proportion to its magnitude; but daily liquid assets rebounded within the ensuing several days, typically a result of WLA securities maturing. That is, the “vertical slice” is not actually sold during the “pricing period” or in the “current market conditions” (i.e., the same day as the redemption) that the rule mandates, but soon after when sales are incurred without market impact.

Furthermore, the market events associated with large, unexpected redemptions will often cause the adviser to adjust portfolio holdings or maturity structure. Thus, selling a “vertical slice” is conceptually flawed as some securities would not be ideally sold while others would experience greater than proportional sales. The “vertical slice” concept is therefore inappropriate in exactly the conditions for which it was particularly devised.

iii. The dilution effects implied by the proposed swing pricing rule are not observed

If the dilution effect that swing pricing is alleged to mitigate actually exists, it would be observed by a persistent decline in the NAVs of institutional prime and tax-exempt funds after large outflows. Examining the Fund NAVs in Table A, before and after the redemption, we see that there is no systematic dilutive effect. This is not observed for the reasons outlined above.

- Prior to March 2020, there was just one occasion over this period (12/15/2017) when the Fund NAV declined on the day of a net redemption greater than 4% of AUM.
- In this case the NAV declined from 1.0001 on the prior day to 1.0000 and returned to 1.0001 on the subsequent day.
- However, daily liquid assets rose from 26.15% on the prior day to 30.54% on the day of the redemption and were 30.97% on the subsequent day. Thus, the Fund was able to anticipate need for daily liquidity and increased it appropriately.
- Consequently, we can infer that the fluctuation in Fund NAV was due almost entirely to market events with at most de minimis effects from any market impact.

iv. The lessons of March 2020

The Commission provides no evidence that the absence of swing pricing has harmed investors, or would have ameliorated the problems of March 2020. During the height of the March 2020 crisis, the Proposal reports that:

prime money market funds sold an estimated ... [\$23 billion] in the secondary market. Thus, we find that prime money market funds, particularly institutional funds, were engaging in greater than normal selling activity in these markets which, when combined with similar selling from other

market participants such as hedge funds and bond mutual funds, both contributed to, and were impacted by, stress in short-term funding markets.³⁶

However, no evidence is provided to demonstrate that these sales created material dilution for remaining shareholders. Moreover, the sale of longer dated securities almost certainly related to the advisers' inability to use WLA to meet redemptions. Indeed, the Commission acknowledges that such sales may have resulted from the flaw in current 2a-7 connecting WLA levels with mandatory board action:

We considered several factors that may have driven investors' redemptions during this period of market stress, including the potential for the imposition of fees and gates as funds neared the 30% weekly liquid asset threshold.³⁷

Moreover, the Commission itself acknowledges the absence of an observed effect:

Staff analysis and an external study did not find a correlation between market prices and institutional prime fund redemptions during this time.³⁸

FHI's own experience bears this out:

- During March 2020, Table A (p. 33) shows that net redemptions from the Fund greater than 4% occurred on Monday March 16th and Tuesday March 17th (totalling 13.02%); and DLA declined from 25.98% on Friday to 19.40% on Tuesday (for a decline of 6.58 percentage points). From Friday to Tuesday, the Fund NAV declined from 1.0003 to 1.0001 representing a reduction of 2 basis points. The Fed's MMLF program was announced on Wednesday March 18. Total redemptions on Wednesday – Friday were 11.63%, but DLA remained stable at 19+ % and increased to 23.6% on Friday. From Tuesday to Friday, the Fund NAV declined from 1.0001 to .9989 for a reduction of 12 basis points. Net redemptions over the entire week approximated 24% of initial AUM.
- Importantly, before the MMLF program was launched the Fund was able to meet redemptions almost entirely out of daily liquidity which, due to the management of weekly liquid assets ("WLA"), automatically grows, as securities mature, to meet any additional redemptions. Over this period, the market was essentially frozen and asset sales in the Fund represented (approximately) only 8% of Fund assets, compared to approximately 24% in redemptions. Sales were driven by the need to maintain WLA greater than 30%. The impact of market sales of securities during this period was a fraction of 1 basis point of NAV, which is entirely within the concept of a floating NAV.³⁹ This compares with a total NAV decline of 14 basis points, which was almost

³⁶ Release at 24-25.

³⁷ Release at 18.

³⁸ Release at 21.

³⁹ On March 17th, the Fund sold approximately \$200 million of securities presenting approximately 0.8% of Fund assets. Losses on these securities represented approximately 0.07 of one basis point. Over March 18th – 20th, the Fund sold approximately \$1.741 billion of securities representing approximately 8% of fund assets. Losses on these securities represented approximately 0.5 of one basis point. The estimated losses in basis points are overstated because they represent losses versus the original purchase price and not versus the prior NAV strike valuation.

entirely due to mark-to-market pricing. With the launch of the MMLF, the fund primarily sold eligible commercial paper into the program, which combined with the organic increase in daily liquidity due to the maturity structure of WLA, enabled the fund to meet redemptions without reducing daily liquid assets. Weekly liquid assets remained above 30% throughout the entire period.

- Over March 15–18, the Fed announced a series of measures to improve the functioning of markets.⁴⁰ These measures began to have a broad positive effect across all markets even before they became effective. Liquidity returned to the short-term market (it thawed) and true price discovery renewed. Without the Fund selling a significant volume of securities into the market at depressed prices, the NAV declined to reflect high-quality short-term (“HQST”) assets being repriced in the market based on the general increase in yields at the short end.⁴¹
- For Federated Hermes Institutional Tax-Free Cash Trust, net redemptions over the period March 16th through March 25th of 2020 totalled, 18.23% of fund assets. This included one day, March 24th, when net redemptions exceeded 4% at 8.22%. However, WLA remained over 99% and the fund NAV remained at 1.000.⁴²

v. Swing pricing will not work or protect investors during events such as March 2020

The market for high-quality short-term assets froze during March 2020. During that period, virtually no transactions were taking place. If transactions are not taking place, even if a theoretical steeply discounted transaction price could be imagined, investors are not being diluted by “market impact costs”. Since swing pricing simply does not work during such periods and is actually meaningless.

vi. The Swing pricing Proposal fails to take into account other requirements of the Release, including the curative effect of eliminating the link between weekly liquid assets and mandatory board consideration of imposing fees or gates

The data cited in this Section II provide clear and compelling evidence that swing pricing will not improve investor protection. Moreover, this finding was obtained under the restrictive requirement of mandatory board action if WLA breached the 30% level, which reduced the ability to use WLA to meet redemptions. The Release proposes to eliminate this restriction, which would have made

⁴⁰ <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315a.htm>
<https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200317a.htm>
<https://www.federalreserve.gov/newsevents/pressreleases/monetary20200317a.htm>
<https://www.federalreserve.gov/newsevents/pressreleases/monetary20200317b.htm>
<https://www.federalreserve.gov/newsevents/pressreleases/monetary20200318a.htm>

⁴¹ For certain securities yielding below 1.25%, the MMLF discounted the price paid for the securities by an amount equivalent to increasing the bid yield by 25bp. However, Federated Hermes did not incur this cost by choosing to sell securities for which this discount did not apply.

⁴² The fund owns primarily variable rate demand notes having a 7 day put.

the management of MMF liquidity even more effective since 2016. Furthermore, the Release also proposes to raise the daily and weekly liquid asset requirement to 25% and 50% respectively. Even if an increase in DLA and WLA is not enacted, and certainly if it is, Funds will have ample liquidity and the swing pricing requirement is utterly redundant.

vii. Swing pricing is a solution in search of a problem

The analysis of this Section demonstrates that swing pricing: (i) fails to materially enhance investor protection; while (ii) significantly impairing investor outcomes through the above-referenced (Section I) adverse consequences. It seeks to address a theoretical problem that is immaterial in practice.

III. The operational challenges posed by swing pricing are onerous

a. Funds that employ swing pricing cannot be used by many intermediaries that transmit trade information via the NSCC

Exhibit 1 (p. 11) illustrates that for Federated Hermes Institutional Prime Value Obligations Fund (“PVOF”), on average, approximately 35.7% of good order trade notices are received after 3:00 pm. This occurs because, as with many similar funds, participating intermediaries are agents of the fund and warrant that these trades were received before 3:00 pm, thus requiring them to receive the T+0 NAV, although they are transmitted through the NSCC and received by the transfer agent and FHI well after 3:00 pm. Under swing pricing, the adviser must have all redemption information, or be able to estimate it with a degree of precision appropriate to fiduciary standards of security valuation, before a market impact adjustment can be calculated. FHI has determined that in the case of PVOF, an estimate of good order redemption notices to be received post 3:00 pm cannot be made with the required precision. Therefore, PVOF will not be available for use by many intermediaries using current market infrastructure. This will deprive those investors of a valuable investment vehicle and further undermine the Commission’s mission of capital formation, market efficiency and competition.

Alternatively, intermediaries may adjust their systems to accelerate the delivery of trade notifications so that they could be received by the fund in time to estimate “market impact costs”, strike an adjusted NAV and wire the proceeds to redeeming investors. We have not received an affirmative response from any intermediaries on this topic and have significant doubt that such investments would be made.

Here we are painfully reminded of the Commission’s statement regarding the adjustments that the industry would make to enable the use of swing pricing under Rule 22c-1:

As discussed in greater detail ... below, we believe that the challenges to implementing swing pricing can be addressed by the fund industry and overcome.⁴³

⁴³ <https://www.sec.gov/rules/final/2016/33-10234.pdf> at 31.

In fact, no such efforts were made and no registered mutual fund has employed swing pricing as permitted by rule 22c-1. One reason is the considerable expense for such an infrastructure change.

b. Multi-strike funds will require complex adjustments to daily operations

Multi-strike funds typically price several times a day, often at 8:00 am, 12:00 pm and 3:00 pm. In these cases, clients or intermediaries can use a variety of data pipes to transmit trade information to the fund by the NAV strike times. Under swing pricing, the adviser would require an additional period of time (45 to 60 min) after the NAV strike time to calculate and validate the net redemptions and any ‘market impact cost’. This requires significant process changes for fund accounting and NAV calculation, and delays the time of wire transmission of redemption proceeds. We have not been able to determine whether fund accountants will be able or willing to undertake the required process changes, particularly in light of the fact that there are relatively few institutional prime and tax-exempt funds remaining in the marketplace; or if they can be completed in a timely manner to allow multi-strike funds to remain viable. Similarly, the delay in sending redemption proceeds by wire may jeopardize the utility of these funds for institutional shareholders.

c. The compliance costs of protecting MNPI that consists of the intent to redeem are unknown in magnitude and must be implemented across the industry

Across both the financial service and non-financial corporate sectors, large volumes of redemptions occur every day; and particularly at common rebalancing dates and other predictable times such as month and quarter ends or tax payment dates. The knowledge of when other investors intend to redeem will become an increasingly valuable material non-public information in determining when to invest in a MMF subject to swing pricing. The industry does not have comprehensive compliance procedures or systems to protect this information. The potential abuses of this information to facilitate illegal trading in MMF funds are significant and costly to prevent.

d. The calculation of “market impact costs” is highly problematic and is unrealistic in stressed market conditions

In normal conditions, it may be possible to develop a valuation procedure to estimate “market impact costs” for a hypothetically traded “vertical slice” of the portfolio. For securities that have already been traded to meet net redemptions, the difference between the traded price and the next vendor prices for the same securities would serve as an indication. However, in this case, it is unlikely that the exact percentage of the fund in the vertical slice would have been the amount traded in that security. Thus, it is more likely that the procedure would rely on a predetermined schedule of estimated “market impact costs” stratified by size of trade for each class of securities owned by the fund (and permitted by the Release). This schedule would be estimated in advance by the adviser working with broker/dealers to develop good faith estimates; and the schedule would require periodic updating over time as market conditions evolve.

However, in unusual periods that are not stress conditions, or in stressed conditions, it is highly likely that the schedule would not reflect good faith estimates based on what the adviser knows

market conditions to be. Consequently, these circumstances would require an “on the fly” revision process that would be subject to significant risk of error and over/under-estimate. We therefore do not believe that this process is realistic for similar reasons that the Commission opted not to require “market impact cost” estimates for under Rule 22c-1.

IV. The SEC’s statutory mandate should not be undermined by the systemic risk objectives of FSOC

The SEC succinctly states its mission:

For more than 85 years since our founding at the height of the Great Depression, we have stayed true to our mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.⁴⁴

Nonetheless, as happened after the 2008 crisis, the SEC is again pressured to adopt a financial stability mandate that would come at the expense of its actual statutory mandate; and, among other things, lead to reforms to Rule 2a-7 in excess of what is required. We believe that any SEC action must *remain true* to its statutory mandate of investor protection, capital formation, market efficiency and competition. Successful execution of this mandate is what has created the foundation of financial stability in the US capital markets; and it should not be diluted to mitigate the risk of another agency failing to timely fulfill its own statutory mandate.⁴⁵ Appendix A provides a detailed account of FSOC’s repeated efforts to force the Commission to adopt reforms that sacrifice its mission and accomplishments based on overstated claims of the risks that open-end funds such as MMFs pose to financial stability. We summarize that account below.

FSOC fails to acknowledge the basic economic fact that significant adjustments in market prices resulting from economic shocks are primarily due to new information being priced in; and secondarily from the purchases or sales that underpin the discovery process. This is established theory supported by extensive empirical data.⁴⁶ Yet FSOC and the Fed continue to base the argument for further regulation of open-end mutual funds and MMFs on the premise that selling in the face of new information is what causes price declines. The allegations are so distorted as to lay significant blame for the turbulence during March of 2020 on open-end fund and MMF asset sales. The SEC should not succumb to this false narrative. The Office of Financial Research 2020 Annual Report contradicts FSOC’s arguments and points out that the markets were reacting to a pandemic and a shutdown of the global economy. Rather than fall prey to FSOC’s disregard for the Commission’s mission in order to achieve its own objectives while avoiding any responsibility,

⁴⁴ SEC, *What We Do*, available at <https://www.sec.gov/about/what-we-do>

⁴⁵ The SEC’s mandate should change only by statute. History shows that excessive outside pressure to go beyond its mandate, particularly in FSOC’s pressure on 2014 MMF reforms, hobbles prime institutional MMFs.

⁴⁶ See for instance, *Efficient Capital Markets: A Review of Theory and Empirical Work*, Eugene F. Fama, *The Journal of Finance* Vol. 25, No. 2, *Papers and Proceedings of the Twenty-Eighth Annual Meeting of the American Finance Association* New York, N.Y. December, 28-30, 1969 (May, 1970), <https://doi.org/10.2307/2325486>

FHI suggests that Congress be urged to direct banking regulators to fix the liquidity problems in the short-term funding markets that were made worse by a mix of government inaction and excessive regulation that choked off market-making and froze out pools of liquidity from those markets. Appendix B summarizes the numerous actions that banking regulators can take to mitigate the adverse impact of banking reforms that destroyed liquidity in stressed markets.

The SEC should not deviate from its statutory mandate of promoting capital formation, market efficiency and competition because the Fed will not fix its own problems; or finds it inconvenient to fulfill its own lender of last resort mandate in crisis conditions that was, in fact, the primary motivation for the adoption of the Federal Reserve Act (“FRA”).⁴⁷

V. Cost/benefit assessment demonstrates that swing pricing is a significant net negative and the Release itself is defective as it fails to fully identify the cost/benefit criteria being employed or appropriately state the related request for public comment

a. The Commission’s proposal for mandatory swing pricing fails to take into account the other requirements of the rule

Most notably the mandatory swing pricing proposal does not take into account the delinking of the 30% WLA test with mandatory board action or the mandated increase in daily and weekly liquid assets. Consequently, the Commission should determine that the current means available to advisers and fund directors, in combination with the proposed liquidity risk management requirements, are inadequate before introducing costly or uncertain new alternatives such as swing pricing.

b. The alleged benefits of swing pricing for systemic risk and investor protection are highly conjectural and cannot be supported by the available evidence

c. While not creating demonstrable benefits, the proposed rule introduces an array of costs and risks that are detailed in Sections I and III

d. The proposal requires that the advisers maintain costly and time-consuming processes to implement swing pricing for every NAV strike, even though the frequency and impact of these events would be de minimis

New valuation procedures to estimate “market impact costs” must be developed, which may be adequate under normal conditions, but are unlikely to be adequate in unusual or stressed market

⁴⁷ The FRA was framed in aftermath of the panics of 1893 and 1907. The Senator Robert Owen, who was a principal author of the FRA, provides a detailed account of the motivation for its adoption: “It should always be kept in mind that ... the main object to be attained ... is the *prevention* of panic [emphasis added], the protection of our commerce, the stability of business conditions, and the maintenance in active operation of the productive energies of the nation which is the question of vital importance.” See https://fraser.stlouisfed.org/files/docs/publications/books/fra_owen_1919.pdf at 43 - 44.

conditions.

e. New adviser and vendor systems and processes must be developed that will be costly and time consuming

Fund accountants must develop new processes and the NAV calculations must be delayed, in FHI's estimation, by at least 45 minutes to an hour to allow calculation and validation of market impact adjustments. Wires for same day settlement of redemption proceeds will be delayed accordingly. It is unclear whether vendors to MMFs will be willing to implement these changes or if investors will be willing to wait the additional time to receive redemption proceeds.

f. A large portion of trades currently receiving T+0 pricing will be forced to T+1 pricing with damaging effect on fund shareholders

For many single strike funds, a large and variable portion of trades, that are warranted by intermediaries to have been placed before the fund designated NAV calculation time, are received by the TA and adviser well after the latest time that the NAV is struck. Under the proposed swing pricing rule, the fund net redemptions and "market impact cost" cannot realistically be estimated in good faith for the trades that are only known to the adviser after the fund's NAV strike time. Consequently, these trades must receive the T+1 NAV. This is likely to materially reduce demand for these funds. Alternatively, intermediaries could potentially retool their systems to deliver the trades to the transfer agent, and the transfer agents may similarly adjust their systems to communicate the trades to advisers in time to calculate a NAV including a market impact factor. However, it is uncertain whether intermediaries or the major vendors to the fund will be willing undertake the significant expense to make the necessary systems changes to accommodate the remaining institutional prime and tax-exempt funds in the market. We have been unable to obtain satisfactory responses to this question from the affected participants.

g. The mandatory swing pricing required by the Release will represent an additional significant impairment of the utility of institutional prime and tax-exempt funds

A preemptive run can be expected, similar to the exodus from these funds before the effective date of the 2014 amendments. This will represent a further significant retreat from the SEC's mission of capital formation, market efficiency and competition.

h. The proposed swing pricing "cure" is worse than the "disease"

FHI estimates that nearly all institutional investors will abandon funds subject to swing pricing. If they were to invest in the nearest alternative – government MMFs – then the annualized reduction in return will be 10 – 12 basis points, based on historical averages of the difference in yields between prime and government funds. This loss compares with an unquantified alleged benefit that FHI expects is near zero, if it can even be measured.⁴⁸

⁴⁸ We have already pointed out the Commission's acknowledgement that it is unable to find a relationship between redemptions and asset prices. (See footnote 38). To provide adequate evidence that swing pricing creates a benefit to

i. The Release is defective as it fails to fully identify the cost/benefit criteria being employed and therefore fails to appropriately seek public comment

It appears that the Commission avoids a rigorous cost/benefit assessment under the view that the relevant issues and related data will be identified through the comment process; and that a final rule will provide a thorough analysis. For instance, the Proposal states:

We request comment on all aspects of the economic analysis of the proposed amendments. To the extent possible, we request that commenters provide supporting data and analysis with respect to the benefits, costs, and effects on competition, efficiency, and capital formation of adopting the proposed amendments or any reasonable alternatives.⁴⁹

However, there are numerous defects in the Release that cannot be cured in this manner. For instance:

- The Release implicitly assumes that the industry will undertake the infrastructure changes necessary to support swing pricing. A similar assumption was made explicitly made with the adoption of Rule 22c-1:

As discussed in greater detail ... below, we believe that the challenges to implementing swing pricing can be addressed by the fund industry and overcome.⁵⁰

These changes were never made, and no domestic 1940 Act funds currently employ swing pricing. The Proposal does not seek public comment from intermediaries, transfer agents, custodians or fund accountants regarding their costs to implement swing pricing; or whether they expect to make the necessary changes on behalf of the 16 institutional funds in the market.⁵¹ In particular, the above-referenced omnibus request for comment does not entitle the Commission to assume that the industry is obligated to provide it all relevant information for a cost/benefit analysis. The Commission is surely aware that this is a threshold issue for the legitimacy of the Proposal. Without this information, the Commission cannot in good faith determine that the Proposal can be implemented and is not a de facto abolishment of institutional prime and tax-exempt funds. Furthermore, the Commission must be aware, and certainly has the responsibility to be aware, of the effect of the failure of the industry to “overcome” the operational obstacles associated with Rule 22c-1. Therefore, the omission of a specific request for public comment, and the implied decision of the Commission to be deliberately uninformed on this matter, renders a future cost/benefit analysis incomplete and meaningless.

- The Proposal is disingenuous when it limits the objective of swing pricing as follows:

shareholders, the Commission would have to demonstrate a material systematic decline in fund NAVs that result from redemptions that equal or exceed 4% of fund AUM. This is not observed in practice.

⁴⁹ Proposal at 270.

⁵⁰ <https://www.sec.gov/rules/final/2016/33-10234.pdf> at 31.

⁵¹ The Proposal identifies that 16 (expressed as 2⁴) funds are impacted by the swing pricing requirement. See Table 7, Release at 275.

Purpose and Terms of the Proposed Requirement We are proposing a swing pricing requirement specifically for institutional prime and institutional tax-exempt money market funds that would apply when the fund experiences net redemptions. This requirement is designed to ensure that the costs stemming from net redemptions are fairly allocated and do not give rise to a first-mover advantage or dilution under either normal or stressed market conditions.⁵²

In fact, the overarching motivation behind the 2014 reforms to Rule 2a-7 and the current Proposal concerns the FSOC's belief that MMFs pose risks to financial stability. The pertinent regulatory history of Rule 2a-7 begins in its most overt form with FSOC's Section 120 letter to the SEC⁵³, continues with the 2014 reforms and concludes most recently with FSOC's February 4th, 2022 release stating:

significant outflows from MMFs during the early stages of the COVID-19 pandemic destabilized short-term funding markets. As in 2008, taxpayer-backed government intervention was necessary to support MMFs and short-term funding markets more broadly and to restore market functioning. These events underscored that MMFs have structural vulnerabilities that can create or transmit stress to short-term funding markets.

The SEC recently proposed reforms that would increase the minimum liquidity requirements for MMFs, require some MMFs to adopt swing pricing, and remove MMFs' ability to impose liquidity fees and redemption gates when funds fall below certain liquidity thresholds. These measures should help reduce the financial stability risks posed by MMFs. The Council supports the SEC's efforts to reform MMFs and strengthen short-term funding markets.⁵⁴

Yet the economic analysis of section III.C.4, that discusses benefits and costs of swing pricing, makes no reference to systemic risk. The Proposal makes only oblique references to this elephant in the room by stating:

Connection between Money Market Fund Outflows and Stress in Short-Term Funding Markets ...where money market funds were able to sell commercial paper during this period, increased selling activity from institutional prime funds may have contributed to stress in these markets as discussed below. Thus, we find that prime money market funds, particularly institutional funds, were engaging in greater than normal selling activity in these markets which, when combined with similar selling from other market participants such as hedge funds and bond mutual funds, both contributed to, and were impacted by, stress in short-term funding markets.⁵⁵

The proposed amendments are intended to reduce run risk, mitigate the liquidity externalities transacting investors impose on non-transacting investors, and enhance the resilience of money market funds. ... The proposed amendments may also reduce the probability that runs would result in future government interventions,⁵⁶

⁵² Release at 44.

⁵³ <https://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf>

⁵⁴ <https://home.treasury.gov/news/press-releases/jy0587>

⁵⁵ Proposal at 23 - 25.

⁵⁶ Proposal at 265.

The Commission is therefore attempting to justify a proposed rule based, in significant part, on an unstated motivation for which it: (i) has no statutory mandate; (ii) has sought no public comment; and (iii) apparently believes it can sidestep a required cost/benefit analysis.⁵⁷ Under normal circumstances, a court may be inclined to give the Commission latitude on this matter; but the aforementioned regulatory history demonstrates the disastrous effect of FSOC pressure leading to the 2014 reforms, whose worst effects the Proposal now seeks to rescind. For this reason, the required cost/benefit analysis justifying a final rule that adopts swing pricing as proposed in the Release will be irreparably flawed; and the imposition of mandatory swing pricing is likely to be found to be arbitrary and capricious.

VI. Federated Hermes Recommendations

a. Federated Hermes recommends that the Commission abandon its swing pricing proposal, and eliminate the link between 30% WLA and mandatory board consideration of fees and gates as proposed

In light of the cost/benefit assessment provided in the foregoing sections, Federated Hermes recommends that the Commission not require swing pricing and recognize that simply removing the link between WLA and mandatory action dramatically reduces first-mover risk while increasing liquidity available to meet redemptions. There is little evidence to the contrary based on the analysis provided here; or the facts and circumstances of March 2020 wherein the Commission appears to base its conclusions on false assumptions:

A mandatory swing pricing regime for net redemptions is intended to address funds' (or fund boards') likely reluctance to impose a voluntary swing pricing regime or voluntary liquidity fee. For example, while money market funds were permitted to impose liquidity fees on redeeming investors under Rule 2a-7 if a fund had less than 30% of its assets invested in weekly liquid assets *no money market fund imposed such fees during the March 2020 market turmoil* [emphasis added].⁵⁸

Yet just 10 pages earlier, the Release provides:

In March 2020, no money market funds imposed liquidity fees, despite the fact that many institutional prime and tax-exempt funds were experiencing significant outflows and some were selling portfolio holdings to meet redemptions, sometimes at a significant loss due to wider spreads given liquidity conditions in the market at that time. *In part, this is due to the design of the current rule, given that only one institutional prime fund had weekly liquid assets below the 30% threshold and could have therefore imposed a liquidity fee* [emphasis added].⁵⁹

Arguing the necessity of swing pricing in this way is superficial analysis of circumstantial evidence. In fact, Exhibit 3 (below) demonstrates that the one institutional prime fund that could have imposed a fee or gate on March 18 had WLA above 30% on the following day.⁶⁰ Based on the cash management disciplines of MMF advisors, it is quite likely that the fund in question

⁵⁷ Perhaps one reason for avoiding this issue is the awareness that swing pricing cannot be demonstrated to reduce systemic risk, and is more likely to increase it.

⁵⁸ Release at 47.

⁵⁹ Release at 36 - 37.

⁶⁰ Also note that several Fed programs were announced during the week of March 16th, including the MMLF on March 18th.

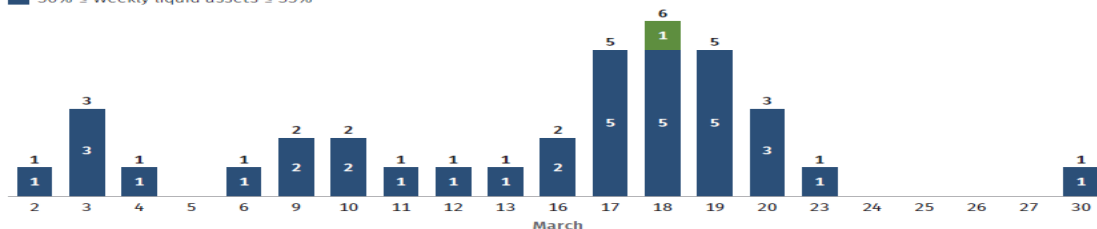
determined that no fee or gate was required, possibly in light of anticipated securities maturing on the 19th. Moreover, the fact that “*some* were selling portfolio holdings to meet redemptions, *sometimes* at a significant loss due to wider spreads given liquidity conditions in the market at that time” was a likely consequence of the desire to avoid the effective 30% WLA floor (that if pierced could instigate larger redemptions), that has now been eliminated in the current rule proposal.

Exhibit 3⁶¹

Number of Institutional Prime Money Market Funds with Weekly Liquid Assets Below 35 Percent

Daily, March 2–March 30, 2020

■ Weekly liquid assets < 30%
■ 30% ≤ Weekly liquid assets ≤ 35%

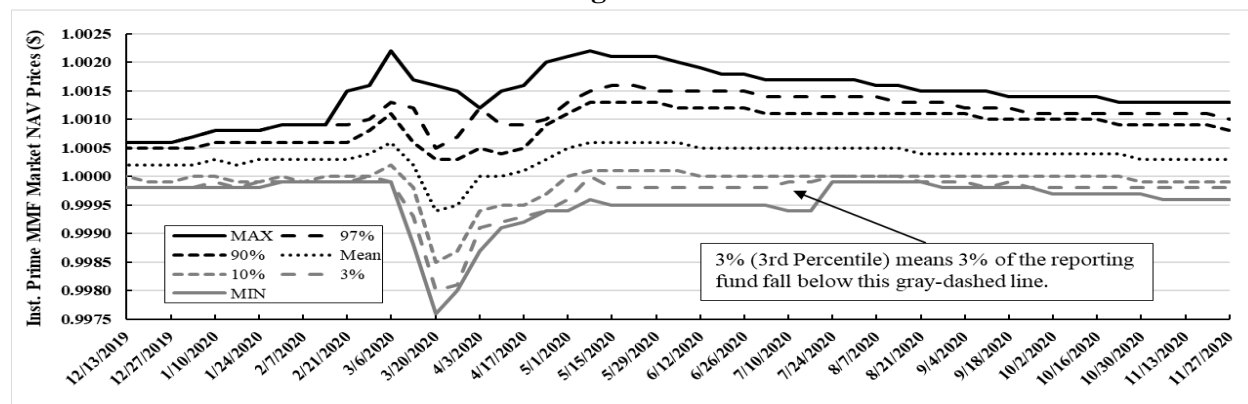


Source: ICI calculations of Crane data

Furthermore, the NAV declines generally experienced were entirely within the concept of a floating NAV. Exhibit 4 shows Figure 11 of the Release (at 167). Note that the decline in institutional fund NAVs was the greatest in mid-March at about 15 basis points. For the vast majority of funds there was a rebound to early March levels by mid-May showing the decline was mark-to-market pricing and not market impact.

Exhibit 4⁶²

Distribution of Weekly Institutional Prime Money Market Fund Market NAVs During COVID-19



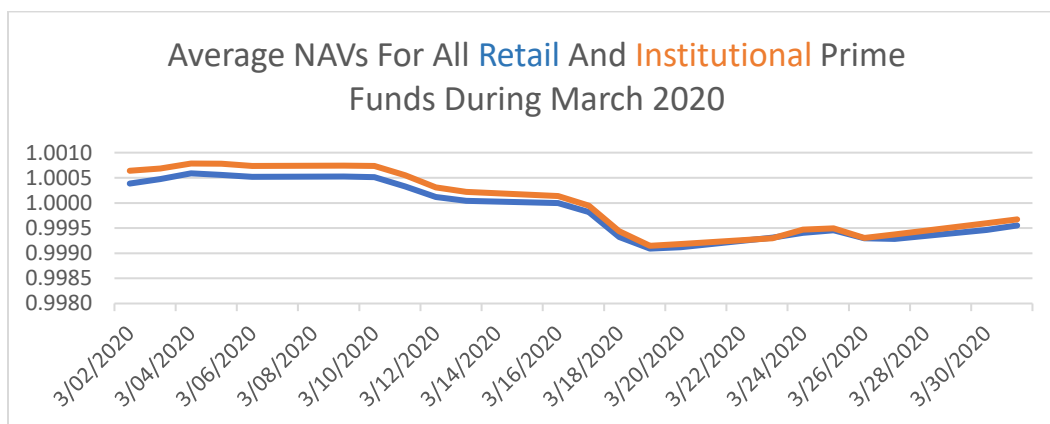
⁶¹ <https://www.sec.gov/comments/credit-market-interconnectedness/cl10-8026117-225527.pdf> at 31.

Exhibit 3 illustrates institutional prime fund WLA levels in March of 2020. The vast majority of the 41 prime institutional MMFs in the marketplace had weekly liquid assets in excess of 35% throughout March. Indicated in blue are the number of funds with WLA between 30% and 35%. Only one fund, on March 18th, had a WLA below 30%, and its value was 27.4%.

⁶² Exhibit taken from Release at 167.

Exhibit 5 shows a comparison of the average NAVs of all retail and institutional funds (and share classes). The average NAV of all retail prime funds declined by approximately 14 basis points over this period before beginning to rebound. On average, institutional fund NAVs declined by slightly more, but began rebounding by more by April. FHI's own experience was that the 14 basis point decline in NAV from 1.0003 on March 13th to 0.9989 on March 20th was almost entirely mark-to-market. *Here again the Commission must guard against the fallacy of attributing price movements to flows rather than the market repricing securities. Virtually all prime fund NAV movement in March of 2020 resulted from mark-to-market adjustments.*

Exhibit 5



Source: FHI calculation of iMoneyNet data

b. Discretionary Liquidity fees are preferable to swing pricing

If the Commission were to conclude that, in addition to the increase in available liquidity as provided in other requirements of the Release, a specific mechanism to require that redeeming shareholders bear material “market impact costs” is necessary, then a liquidity fee is preferred to swing pricing. Although the Commission considered a liquidity fee, it concluded that mandatory swing pricing was preferable:

We considered a framework that would apply the swing factor in the form of a liquidity fee rather than an adjustment to the fund’s price. A liquidity fee could be used to impose liquidity costs on redeeming investors and address dilution, much like a swing pricing-related price adjustment. We recognize that a liquidity fee framework could have certain advantages over a swing pricing requirement. ... While money market funds and their intermediaries should be able to apply liquidity fees under the current rule, we also believe applying dynamic liquidity fees that can change in size from pricing period-to-pricing period may involve greater operational complexity and cost than swing pricing. ... On balance, we believe a swing pricing requirement has operational advantages over liquidity fees, but we request comment on using a liquidity fee framework to impose liquidity costs and whether a liquidity fee alternative may have fewer operational or other burdens than the proposed swing pricing requirement while still achieving the same overall goals.⁶³

⁶³ Release at 60 - 61.

Both swing pricing and liquidity fees pose operational challenges, but as the Release points out, “MMFs and their intermediaries should be able to apply liquidity fees under the current rule.” Therefore, the operational requirements of liquidity fees are contemplated under current law, whereas the operational challenges of swing pricing face an entirely new cost/benefit test. Furthermore, the numerous disadvantages of NAV adjustments identified in Sections I and III have not been considered in the Release. Consequently, liquidity fees are strongly preferred.

c. The functional equivalent of discretionary liquidity fees is already allowed by Rule 22c-2

MMFs are already permitted, but not required, to implement a redemption fee of up to 2% under rule 22c-2; and the Release does not propose to amend this.

While the proposal would remove the liquidity fee provision in rule 2a-7, a money market fund’s board of directors may nonetheless approve the fund’s use of redemption fees (up to but not exceeding 2% of the value of shares redeemed) to eliminate or reduce as practicable dilution of the value of the fund’s outstanding securities under rule 22c-2 under the Act.⁶⁴

Nothing in Rule 22c-2 prevents a board from disclosing that a redemption fee shall be applied from time to time based on specified market conditions and in an amount necessary to recoup any “market impact costs” (of up to 2% but limited to a “good faith” estimation of the true portfolio cost of redemptions, which would be substantially lower than 2% for a MMF that values its portfolio at the bid price and holds a sufficient KYC liquidity buffer above the WLA and DLA minimums) such as when net redemptions exceed a threshold during periods in which short-term funding market emergencies exist that are analogous to September 2008 and March 2020, provided that the board decision is based on the considerations required by the rule. As discussed in this letter, Federated Hermes’ other comment letter on the current proposal, and in our September 13, 2021 Comment letter on the PWG Report on MMFs, a liquidity fee is a far superior alternative to swing pricing, and like Rule 22c-2, should allow tailoring of how, when, under what circumstances and in what amounts liquidity fees should be imposed.

d. Discretionary liquidity fees are preferred to mandatory liquidity fees

The Commission appears to doubt the integrity of independent fund boards to act in the best interest of shareholders or the funds themselves:

even if all institutional money market funds recognized the benefits of charging redeeming investors for liquidity costs, we believe there is a collective action problem in which no fund would want to be the first to adopt such an approach. We believe past experience with the existing liquidity fee regime supports a mandatory approach to dilution mitigation for institutional funds.⁶⁵

If this underlying view is reasonably extrapolated to other similar board decisions, then the Commission is faced with justifying the entire governance structure of 1940 Act funds. Federated

⁶⁴ Release at 39.

⁶⁵ Release at 47.

Hermes disagrees with these conclusions in every respect and the SEC should not further enshrine doubts about the integrity of fund boards in Rule 2a-7 or any other rule amendments.

In particular, just as banking regulators have come to the conclusion that, under certain conditions, “running” is the optimal strategy for bank deposit holders or MMF shareholders, a similar analysis can and should be performed for fund trustees to determine whether or not they would timely implement a discretionary fee. That is, the analysis should be rigorous and not conjectural. *Federated Hermes believes that the Commission’s conclusion fails to differentiate between the interests of the independent board with what the Commission perceives to be the interests of the adviser.* When this distinction is made and “risk/return” attitudes of the independent trustees are critically evaluated, the optimal strategy of the board is to make a timely decision to impose a liquidity fee. We have already pointed out in Section VI.a that the failure of any funds to implement a liquidity fee in March 2020 is not necessarily representative because of the particular circumstances at that time. Thus, basing an entire regulatory regime on that one data point is casual empiricism at best. More generally, the Release’s argument regarding a “collective action problem” is flawed.

A rigorous paper on this subject has already been provided to the Commission in support of the finding that the optimal decision of a fund board is to take action to prevent a run on the fund.^{66,67} In the present case, it is also relevant to understand that fund directors have risk/return preferences that are as prescribed behavioral economics.^{68,69} That is, losses create far greater harm than comparable gains create a benefit. In this case, the decision of a fund board holds an analogy to that of a prisoner in the classic “Prisoner’s Dilemma”.⁷⁰

We find that in the scenario of a fund being at the point of significant market impact in selling securities to meet redemptions, the optimal Nash Equilibrium strategy⁷¹ for independent board directors is to be a first-mover in implementing a discretionary liquidity fee. Consequently, the Commission’s conjecture referenced above is a flawed basis for determining that either a mandatory liquidity fee or mandatory swing pricing is required to protect shareholders and the fund.⁷²

⁶⁶ “Proposed Money Market Mutual Fund Regulations: A Game Theory Assessment” available at <https://www.sec.gov/comments/s7-03-13/s70313-332.pdf>

⁶⁷ The conclusions of that paper should not be confused with the observed fact that the link between the 30% WLA and mandatory board action was feared to instigate redemptions during March 2020.

⁶⁸ For instance, as in the landmark “Prospect Theory” and related work for which Daniel Kahneman won the Nobel Prize in economics, “Prospect Theory: An Analysis of Decision under Risk”, Daniel Kahneman and Amos Tversky, *Econometrica*, Vol. 47, No. 2 (Mar., 1979), pp. 263-292, <https://doi.org/10.2307/1914185>

⁶⁹ Moreover, these may differ from those of the adviser, which are implied by the Release to be served by having a larger fund.

⁷⁰ https://en.wikipedia.org/wiki/Prisoner%27s_dilemma

⁷¹ A Nash Equilibrium optimal strategy is characterized by the condition that a decision-maker will adopt that strategy regardless of the strategies of adopted by other decision-makers, even if known to the decision-maker.

⁷² To summarize, assume that there are N ($N \geq 5$) similar funds in the market, and that an individual fund board believes that at least several other funds own similar securities, subject to the same pricing/liquidity conditions; and that all funds have institutional investors with similar risk/reward preferences. If the fund were not to impose a

e. Mandatory liquidity fees, as contemplated by some commenters, are defective in that they will exacerbate redemptions in stressed markets

Experience from the 2014 Rule 2a-7 reforms generally, and the link of mandatory board action with the 30% WLA level during March 2020, clearly demonstrate that any mandatory imposition of liquidity fees will exacerbate redemptions, particularly in stressed market conditions. The Release's conjecture to the contrary, as discussed in Section I.a, defies both experience and the known rational behavior of risk averse investors.

f. Federated Hermes recommends that the SEC not be ensnared in a redirection or usurpation of its defined mission toward goals that cannot be reconciled with its statutory mandate

Such usurpation could easily lead to legal challenges as actions not supported by the facts or applicable law. Any such revisions should result from legislation that defines the role of financial stability in relation to existing statutory mandates for the applicable federal agencies, with particular attention to the SEC's mandate of investor protection, orderly markets, efficiency and capital formation that promote economic activity.

g. Congress should encourage banking regulators fix the problems created by the array of post-financial crisis reforms that materially impaired market-making, particularly in stressed market conditions

Federated Hermes has identified numerous steps that can and should be taken in Appendix B.

h. Even with further banking reforms, there is an overlap of the SEC's mandate with financial stability: liquidity, which is essential for orderly markets

The path to financial instability begins with a shock to the system that induces deep uncertainty in valuations and a failure of price discovery. There may be a particular market that is first affected, but depending on the interconnectedness, that is often itself unknown to market participants,

liquidity fee under these conditions, the independent directors face the likelihood that another fund will. In this case, all investors are likely to assume that all funds face similar conditions and a run on the funds not adopting fees would ensue. This will create severe penalties for the directors including SEC enforcement actions, shareholder litigation, and severe reputational harm. Under the risk/return preferences of behavioral economics, the penalties of not imposing a fee far outweigh the benefits to independent directors who earn a fixed fee for their services to the fund and not the economic benefits of a larger fund. Consequently, it is optimal for the board to implement the liquidity fee. Since this analysis is performed by every fund under the assumed circumstances, it will be optimal for all funds at the point of incurring material market impact costs to fund redemptions to also implement a liquidity fee. Hence, all boards whose funds are in this circumstance are motivated to be first-movers to implement a liquidity fee. If despite the inability to know so, an individual fund board believed that all other funds would not impose liquidity fees, that fund is still in the assumed circumstance of incurring material market impact costs to fund redemptions. The related penalties to fund directors still apply for any ensuing harm to shareholders. Consequently, the individual fund board in that circumstance would still determine to impose a liquidity fee. In this instance, the fund is not motivated to be a "first-mover", but the strategy is optimal nonetheless. Thus, whether other funds are expected to implement a fee or not, it is still optimal for the individual fund to do so. Therefore, this strategy represents a Nash Equilibrium for that fund.

contagion may cascade to other parts of the market. With uncertainty of the price floor, there are either no bids or bid/ask spreads widen dramatically. Liquidity dries up. Therefore, liquidity is a clear point of crisis intervention that regulation and market infrastructure can both address. It is the medium through which price discovery takes place, capital is rationally allocated, decisions more thoughtfully made, and contractions are mitigated.

Within the SEC, the Division of Trading and Markets oversees market liquidity, among other things. The SEC's regulation of fixed income markets, including alternative trading systems (ATS, or electronic venues), has promoted market efficiency and lowered trading costs in normal periods, but this has not necessarily translated to improved liquidity in turbulent periods. The SEC's Division of Investment Management has taken steps to enhance the liquidity risk management of mutual funds generally,⁷³ and MMFs in particular,⁷⁴ in recent years. We suggest that the SEC focus greater attention on regulations that can enhance liquidity in fixed income and short-term markets in crisis periods. More generally, we recommend that the Division of Trading and Markets undertake a thorough review of the money markets to identify additional means of improving liquidity during stressed market periods.⁷⁵

VII. Conclusions

As documented above, mandatory swing pricing offers no tangible benefits for systemic risk and investor protection. The alleged benefits are unsubstantiated by data or analysis and are largely conjectural. But costs and risk associated with mandatory swing pricing as proposed are real, demonstrable and significant. Less onerous alternatives, as outlined above, have been dismissed without meaningful analysis. If implemented as proposed, we believe that the Proposal would be found to be arbitrary and capricious.

Prime and tax-exempt money market funds ("MMFs") have been among the most successful financial products in history providing investors with over \$200 billion in returns in excess of bank deposit rates since 1990 while significantly lowering borrowing costs for corporations and municipalities.⁷⁶ Just two MMFs have ever "broken the buck", with zero cost to taxpayers, and investors recovering over 96% percent of their principal in one case and over 99% of their principal in the other.⁷⁷ Over this same period, over 3,600 federally insured depositories have failed

⁷³ See SEC Rule 22e-4, 17 C.F.R. 270.22e-4; SEC-IM, Risk Management in Changing Fixed Income Market Conditions, Guidance Update 2014-01 (Jan. 2014) *available at* <https://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf>.

⁷⁴ See 2010 and 2014 amendments to SEC Rule 2a-7 *available at* <https://www.sec.gov/rules/final/2010/rule2a-7amendments.pdf>.

⁷⁵ For a more detailed discussion of steps the SEC can take to improve liquidity during turbulent periods see Federated Hermes Comment Letter II, *available at* <https://www.sec.gov/comments/s7-01-21/s70121-8861709-240107.pdf>

⁷⁶ See Federated Hermes First Comment Letter, <https://www.sec.gov/comments/s7-01-21/s70121-8662821-235311.pdf>, at 3-4.

⁷⁷ See Cochran, Freeman, Clark, Money Market Fund Reform: SEC Rulemaking in the FSOC Era, 2015 COLUM. BUS. L. REV. 861 (2015) at 884-885.

costing taxpayers over \$180 billion,⁷⁸ which should provide some helpful perspective for those who assert that it's MMFs that have “structural vulnerabilities” or needed “taxpayer bailouts”.

Federated Hermes strongly supports reforms to improve the resilience of these funds, but will vigorously oppose further regulatory damage to the utility of these important products, such as predictably occurred from the 2014 amendments.

* * * * *

We appreciate the opportunity to present our views on this topic and hopes that you find them useful and constructive. We welcome any questions you may have and are happy to meet to discuss any matters in further detail.

Very truly yours,



Michael R. Granito
Chief Risk Officer



Deborah Cunningham, CFA
Executive Vice President, Chief Investment
Officer of Global Liquidity Markets

cc: Gary Gensler, Chair, Securities and Exchange Commission
Hester M. Peirce, Commissioner, Securities and Exchange Commission
Allison Herren Lee, Commissioner, Securities and Exchange Commission
Caroline A. Crenshaw, Commissioner, Securities and Exchange Commission
Dan Berkovitz, General Counsel, Securities and Exchange Commission
William A. Birdthistle, Director, Division of Investment Management
Sara ten Siethoff, Deputy Director, Division of Investment Management's Rulemaking
Office, Securities and Exchange Commission

⁷⁸ See Federal Deposit Insurance Corporation (“FDIC”), Bank Failures & Assistance Data, *available at* <https://banks.data.fdic.gov/explore/failures> (last visited Apr. 8, 2022).

Table A: Institutional Prime Obligation Fund – Occurrences of Net Redemptions > 4%: 3/31/17 to 12/31/21 *

Date	Net Redemptions (%)	Daily Liquidity (%)	Weekly Liquidity (%)	NAV
03-30-2017	0.52%	13.91	42.75	1.0002
03-31-2017	-6.83%	16.06	41.08	1.0002
04-03-2017	0.56%	15.20	40.47	1.0002
05-19-2017	-0.66%	17.31	45.13	1.0003
05-22-2017	-5.16%	16.58	43.85	1.0003
05-23-2017	-0.70%	23.38	44.19	1.0004
07-14-2017	-0.06%	17.40	38.55	1.0003
07-17-2017	-8.47%	12.61	35.31	1.0003
07-18-2017	19.98%	27.03	46.37	1.0003
07-28-2017	-0.04%	28.60	48.13	1.0003
07-31-2017	-8.99%	16.04	41.06	1.0003
08-01-2017	-4.18%	16.93	38.76	1.0003
08-02-2017	NA**	20.60	44.73	1.0003
08-30-2017	-0.16%	13.33	38.31	1.0003
08-31-2017	-6.47%	19.12	37.44	1.0003
09-01-2017	-0.30%	22.82	38.34	1.0003
12-06-2017	-0.14%	16.56	38.61	1.0001
12-07-2017	-5.81%	16.89	38.44	1.0001
12-08-2017	-1.77%	18.29	35.86	1.0001
12-14-2017	-0.92%	26.15	40.16	1.0001
12-15-2017	-4.53%	30.54	39.86	1.0000
12-18-2017	0.07%	30.97	40.90	1.0001
01-31-2018	7.12%	31.51	39.74	1.0001
02-01-2018	-5.77%	27.88	39.89	1.0001
02-02-2018	2.35%	29.15	40.35	1.0001
06-28-2018	-0.15%	26.31	38.09	1.0002
06-29-2018	-4.63%	26.88	39.57	1.0002
07-02-2018	-0.05%	25.26	38.65	1.0002
09-27-2018	-3.25%	27.99	37.66	1.0003
09-28-2018	-4.08%	25.10	38.11	1.0003
10-01-2018	0.47%	26.87	39.30	1.0003
04-23-2019	1.02%	34.97	39.17	1.0003
04-24-2019	-4.21%	31.42	37.63	1.0003
04-25-2019	0.93%	29.83	38.12	1.0003
07-23-2019	-0.20%	31.74	40.81	1.0004
07-24-2019	-4.34%	31.86	39.25	1.0004
07-25-2019	-0.13%	34.44	41.75	1.0004
10-30-2019	4.08%	33.63	43.37	1.0004
10-31-2019	-4.48%	29.95	39.43	1.0004
11-01-2019	-0.84%	27.90	40.01	1.0004
03-13-2020	-0.02%	25.98	36.77	1.0003
03-16-2020	-4.81%	22.57	35.35	1.0002
03-17-2020	-8.21%	19.40	32.79	1.0001
03-18-2020	-3.92%	19.12	31.33	0.9994
03-19-2020	-4.18%	19.75	31.20	0.9989
03-20-2020	-3.53%	23.60	33.73	0.9989

* Data for the day before, day of, and day after net redemptions of greater than 4%. **Large positive inflow from another FHI institutional MMF

Appendix A

The SEC's Statutory Mandate Should Not Be Undermined By The Systemic Risk Objectives Of FSOC

The SEC succinctly states its mission:

For more than 85 years since our founding at the height of the Great Depression, we have stayed true to our mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.⁷⁹

Nonetheless, as happened after the 2008 crisis, the SEC is again pressured to adopt a financial stability mandate that would come at the expense of its actual statutory mandate; and, among other things, lead to reforms to Rule 2a-7 in excess of what is required. We believe that any SEC action must *remain true* to its statutory mandate of investor protection, capital formation, market efficiency and competition. Successful execution of this mandate is what has created the foundation of financial stability in the US capital markets; and it should not be diluted to mitigate the risk of another agency failing to timely fulfill its own statutory mandate.⁸⁰

a. FSOC's fundamental failure to acknowledge the underlying causes of market turbulence

One of the singular accomplishments of the SEC over its 85 years has been its focus on market efficiency. This is enabled by through, timely and accurate disclosures by companies; and by maintaining fair and orderly markets. The edifice of financial theory and empirical work since the 1960s has demonstrated that newly arriving information is quickly reflected in security prices. This broad finding ended the prior debate regarding the major determinant of price changes: (i) buying or selling pressure; or (ii) material new information regarding fundamental valuation. To justify its agenda, FSOC and the Fed cling to the former antiquated theory.

b. The SEC should not adopt FSOC's false narrative

After the 2008 financial crisis and the passage of DFA, the SEC was faced with the challenge of adopting new MMF reforms amid a dramatically changed regulatory landscape. In particular, FSOC's DFA Section 120 action drove the SEC to adopt additional MMF reforms through the lens of financial stability, which is not within the SEC's statutory mandate.⁸¹ During the MMF reform debate, the chair of the SEC, Mary Jo White, participated as a member of FSOC. In July of 2020,

⁷⁹ SEC, *What We Do*, available at <https://www.sec.gov/about/what-we-do>

⁸⁰ The SEC's mandate should change only by statute. History shows that excessive outside pressure to go beyond its mandate, particularly in FSOC's pressure on 2014 MMF reforms, hobbles prime institutional MMFs.

⁸¹ Here it is important to distinguish between "financial stability" and "market efficiency". Efficiency primarily refers to reduced costs of intermediation, or other categories of expense, timely and accurate disclosure of material financial information, and the ability of the markets to quickly price in new information. This will not necessarily imply low volatility or "stability" if new information implies significant price corrections.

Treasury Secretary Janet Yellen, who was Chair of the Fed during the MMF reform debate, provided an account of FSOC's efforts to persuade the SEC to adopt a financial stability mandate that could apparently supersede other elements of the SEC's mandate.⁸²

Money-market funds, another example. It was almost impossible for FSOC to get at, that was the top of FSOC's to-do list when it was formed in 2010. It was incredibly difficult for FSOC to persuade the SEC to address systemic risk in these funds.

Yellen said she recalled a speech by one of the SEC commissioners about money-market funds, with the commissioner saying oversight of those funds wasn't in the agency's mandate.

I do think a big problem here is that FSOC was not given any powers of its own to address things like money market reform, or problems in asset management or hedge funds," she said. "And the SEC and other regulators also didn't have any change in their mandates that would force them to address systemic risk. And this commissioner gave his speech, saying, this simply isn't our job."⁸³

With Secretary Yellen now chairing FSOC, the pressure on the SEC to adopt a financial stability mandate is now amplified. One of the problems in regulating on the basis of systemic risk is that, despite the efforts of the Office of Financial Research to identify and quantify financial stability risks, it is difficult to define beyond generalizations, and impossible to measure in the sense of actual probabilities and costs. There is a tendency of those who embrace this mandate to hold the view that, although the probability of a systemic event taking place may be low (such as the 2020 pandemic), the cost is so great that regulation is warranted, even if it could be crippling to market functions that are mandates of other agencies, in this case the SEC. In these matters, when there is no common ground, debates often devolve to false narratives, platitudes and even politics. FSOC's February 4th, 2022 announcement amply demonstrates this:

Nonbank financial institutions (NBFIs) are an essential source of capital in financial markets and provide vital funding to the U.S. economy. In 2016, the Financial Stability Oversight Council (Council) issued a statement describing risks to financial stability that may arise from certain asset management products and activities.^[1] The market dislocations of March 2020 demonstrated that some NBFIs remain vulnerable to acute financial stresses and may amplify or transmit stress in the financial system. In 2021, the Council made it a priority to evaluate and address the risks to U.S. financial stability posed by three types of NBFIs: hedge funds, open-end funds, and money market funds (MMFs). At its meeting on February 4, 2022, the Council received updates from member agency staff on progress over the past year regarding these three types of NBFIs through working groups and Council member agency rule-making activity. The Council will continue to evaluate, monitor, and address these risks to financial stability in 2022.

⁸² Dodd Frank Update, *Former Fed chair Yellen wants new Dodd-Frank* (July 17, 2020) available at <https://www.doddfrankupdate.com/DFU/ArticlesDFU/Former-Fed-chair-Yellen-wants-new-DoddFrank-79789.aspx>

⁸³ Dodd Frank Update, *Former Fed chair Yellen wants new Dodd-Frank* (July 17, 2020) available at <https://www.doddfrankupdate.com/DFU/ArticlesDFU/Former-Fed-chair-Yellen-wants-new-DoddFrank-79789.aspx>

In 2021, the Council also established an interagency staff-level Open-end Fund Working Group to assess potential risks to U.S. financial stability arising from open-end funds, particularly their liquidity and redemption features. This working group evaluated the role of open-end funds in the market stress that occurred during the early stages of the COVID-19 pandemic, when large-scale investor redemptions prompted funds to liquidate assets. U.S. open-end funds were among the largest recorded sellers of U.S. Treasuries, U.S. municipal bonds, and possibly U.S. corporate debt during this period. The impact of these asset sales on U.S. fixed income markets, together with sales by other investors, was magnified by poor liquidity and stressed trading conditions. *Open-end funds were not the sole or primary cause of market stress—there was no single, primary cause—but the size of their asset liquidations indicates that they were one of the significant contributors to this stress* [emphasis added].

The Council supports the Open-end Fund Working Group’s continued analysis of the potential risks to financial stability that may arise from liquidity transformation at open-end funds. SEC staff is considering whether to make recommendations regarding potential reforms of open-end funds to enhance resiliency during stressed market conditions, and the Council is encouraged by the SEC’s continued engagement on this critical issue.⁸⁴

This excerpt evidences FSOC’s over-reach to further regulate the mutual fund industry under the allegation that open-end funds are a grave source of financial stability risk. The preponderance of empirical and theoretical research contradicts this conclusion.

d. The analysis by the Office of Financial Research contradicts FSOC’s argument

The Office of Financial Research (“OFR”) 2020 Annual Report directly contradicts FSOC’s assessment that “there was no single, primary cause” of the March 2020 market turbulence, that FSOC uses to lay the groundwork for alleging that “the size of [open-end fund] asset liquidations indicates that they were one of the significant contributors to this stress.”

This threat to stability in 2020 had an origin different from the financial crisis of 2007-09, the international debt crises of the 1990s, the mortgage and sovereign debt crises of the 1980s, the oil crises of the 1970s, the economic collapse of the 1930s, the panic of 1907, or various 19th century panics. This time, the trigger was exogenous to the financial system — a new, virulent virus that rapidly became a global pandemic, resulting in growing infections; deaths; great public fear; and disruptions to families, businesses, and lives worldwide. In response came aggressive and unprecedented government actions to combat the pandemic. The pandemic itself, combined with these actions, had severe short term economic costs, including a steep recession. More than 50 million people lost their jobs, many companies filed for bankruptcy or restructured their operations, and many sectors experienced sharp declines. *Financial markets, anticipating the economic effects*

⁸⁴ <https://home.treasury.gov/news/press-releases/jy0587> (citing Financial Stability Oversight Council, “Update on Review of Asset Management Products and Activities” (April 18, 2016), available at <https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf> [lnks.gd])

and faced with massive uncertainty, experienced considerable turbulence in March [emphasis added].⁸⁵

Fortunately, the OFR saw beyond FSOC’s false narrative when it commented that: “Financial markets, anticipating the economic effects and faced with massive uncertainty, experienced considerable turbulence in March.”⁸⁶ Even the Fed’s own Randal Quarles, then Fed vice chair for supervision and chair of the FSB commented in October 2020:

It may be that there is a simple macro fact that the Treasury market being ... much larger than it was a decade ago and now really much larger than it was even a few years ago, that the sheer volume there may have outpaced the ability of the private market infrastructure to support stress of any sort there⁸⁷

Figure 1 illustrates Quarles’s point.

Figure 1
Treasury volatility rises in 2020 to the level of 2009



Source: Bloomberg

e. FSOC’s false narrative continues on the topic of MMFs

FSOC goes on to state that

MMFs are significant participants in short-term funding markets, which are a substantial source of funding for businesses and local governments and liquidity for investors. As described in the *Overview of Recent Events and Potential Reform Options for Money Market Funds* released by the President’s Working Group on Financial Markets in December 2020,^[2] significant outflows from MMFs during the early stages of the COVID-19 pandemic destabilized short-term funding markets. As in 2008, taxpayer-backed government intervention was necessary to support MMFs and short-term funding markets more broadly and to restore market functioning. These events

⁸⁵ <https://www.financialresearch.gov/annual-reports/files/OFR-Annual-Report-2020.pdf> at 11.

⁸⁶ <https://www.financialresearch.gov/annual-reports/files/OFR-Annual-Report-2020.pdf> at 11.

⁸⁷ Benjamin Purvis and Catarina Saraiva, *The Treasury market May Be So Big That the Fed Can’t Step Away*, (Oct. 14, 2020 5:03 PM), available at <https://www.bloomberg.com/news/articles/2020-10-14/the-treasury-market-may-be-so-big-that-the-fed-can-t-step-away?sref=enGs3N51>.

underscored that MMFs have structural vulnerabilities that can create or transmit stress to short-term funding markets.

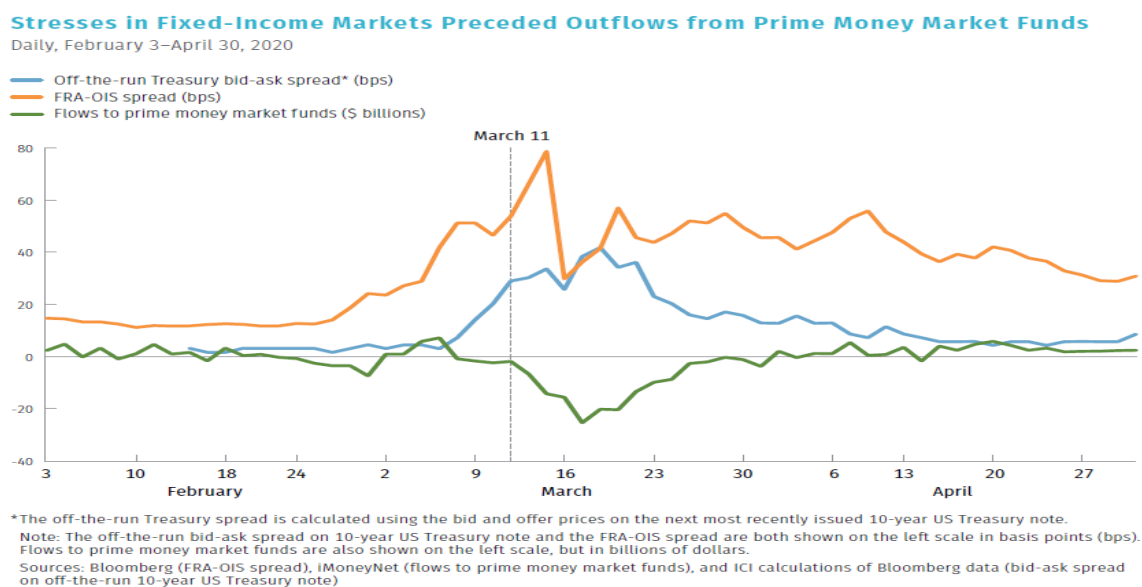
The SEC recently proposed reforms that would increase the minimum liquidity requirements for MMFs, require some MMFs to adopt swing pricing, and remove MMFs' ability to impose liquidity fees and redemption gates when funds fall below certain liquidity thresholds. These measures should help reduce the financial stability risks posed by MMFs. The Council supports the SEC's efforts to reform MMFs and strengthen short-term funding markets.⁸⁸

Here again FSOC falsely portrays history to create the appearance of an amplified risk to taxpayers from MMFs. In fact, in its required report to Congress on the MMLF, the Fed concluded:

...the Board does not expect at this time that advances under the MMLF will result in any losses to the Federal Reserve or the taxpayer.⁸⁹

And no such losses occurred. Furthermore, the notion that the actions of money MMFs destabilized the short-term funding markets during the early stages of the pandemic is patently false. Figure 2 illustrates that corporate spreads had already widened dramatically before March 16th, when institutional MMFs began to experience significant net redemptions.

Figure 2⁹⁰



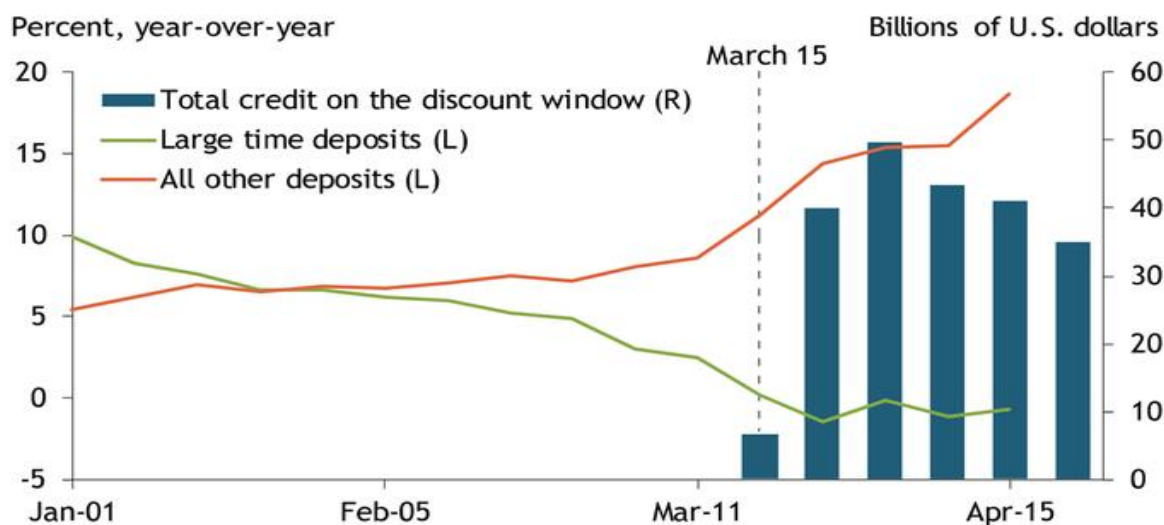
⁸⁸ <https://home.treasury.gov/news/press-releases/jy0587> (citing <https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf> [lnks.gd]).

⁸⁹ <https://www.federalreserve.gov/publications/files/money-market-mutual-fund-liquidity-facility-3-25-20.pdf> at 4.

⁹⁰ https://www.ici.org/system/files/attachments/pdf/20_rpt_covid3.pdf at 15.

Figures 2 and 3 show that the crisis conditions emerged long before significant outflows from MMFs had begun, and that the Libor-OIS spread (reflecting commercial paper spreads) had widened from under 20 bp before the onset to nearly 80 bp. When MMF outflows began in the 3rd week of march, the flight to cash had been underway since early February when large time deposits were being liquidated in favor of demand deposits or government MMFs.

Figure 3 ⁹¹



Here again, it is concerning that FSOC and the Fed are setting forth a false portrayal of historical facts to lay the groundwork for further regulation of MMFs. In fact, the intent to diminish the role of MMFs in the US financial system has been a longstanding objective of the Fed. For instance, the “Author’s Note” of a 2010 Federate Reserve Bank of New York staff report ⁹² states: “Its aim is to aid regulators and policymakers globally to reform, regulate and supervise the process of securitized credit intermediation in a market-based financial system.” The report goes on to state:

it is imperative for policymakers to assess whether shadow banks should have access to official backstops permanently, *or be regulated out of existence* [emphasis added]. ⁹³

f. Congress should direct banking regulators to fix the liquidity problems they created and not force their problems onto other regulators

The SEC’s regulation of fixed income markets, including alternative trading systems (ATS, or electronic venues), has promoted market efficiency and lowered trading costs in normal periods, but this has not necessarily translated to improved liquidity in turbulent periods. A major challenge

⁹¹ <https://www.kansascityfed.org/research/economic-bulletin/global-pandemic-run-shadow-banks-2020/>

⁹² Available at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr458_July_2010_version.pdf or from Federated Hermes, Inc. (the “Report”)

⁹³ Report at 6.

for the SEC's regulatory initiatives for promoting liquidity is that the prescriptions for orderly markets and efficiency in normal periods are quite different from those in crisis periods.

These are the periods when combined effects of numerous banking regulations established subsequent to the 2008 financial crisis take their toll. For example, the Basel III capital requirements, the Supplementary Leverage Ratio ("SLR"), the Volker Rule, the Liquidity Coverage Ratio ("LCR"), the Net Stable Funding Ratio ("NSFR") requirement, stress test requirements and others have had a significant adverse impact on market liquidity. In these environments, bank broker-dealers are working to assure their own liquidity before providing it to the market, even as trading revenue can improve due to the widened bid/ask spreads on what is traded. In this regard, banking regulators have themselves impaired the functioning of the markets by post-financial crisis reforms that have diminished market-making by broker/dealers, thus taking direct action contrary to the Commission's statutory mandate. Numerous academicians and other regulatory bodies have made this clear.⁹⁴

In fact, the Commission's own words make the point. In December 2015, Congress directed the SEC's Division of Economic and Risk Analysis to report on the impacts of the Dodd Frank Act, the Volker Rule and other financial regulations on market liquidity in U.S. Treasury and corporate debt markets. Here the Commission finds:

While there is little consensus in existing work concerning the direction, causal attribution, and mechanisms behind observed changes, evidence suggests that in recent years dealers have been less likely to engage in risky principal transactions. In addition, dealers generally decrease liquidity provision in times of severe market stress, such as during the financial crisis.

Evidence from the crisis [of 2008] suggests that during times of severe market stress, dealers may not lean into the wind, but instead make larger cuts in inventory of bonds that are aggressively sold by their customers. Such evidence supports a finding that dealers decrease liquidity provision in times of severe market stress.⁹⁵

g. Actions that banking regulators can take to mitigate the adverse impact of banking reforms that destroy liquidity in stressed markets

To be clear, we understand that mitigating the on-set of, and preventing the damage from, a financial crisis are daunting responsibilities that requires constant vigilance. It is understandable that the Fed could seek to impose macroprudential regulation on all financial products to withstand significant, even catastrophic, events without Fed intervention. However, there is a point at which this imposes too great a cost on business and the economy; and the Fed must ultimately step in to address a true crisis.⁹⁶ This is particularly relevant in light of the Fed's current realization that the

⁹⁴ For a detailed account of these issues see 2021 Federated Comment Letter 2 available at <https://www.sec.gov/comments/s7-01-21/s70121-8861709-240107.pdf>

⁹⁵ SEC, *Access to Capital and Market Liquidity* (Aug. 2017) available at <https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-2017.pdf>, at 9.

⁹⁶ In fact this was the original purpose of the Federal Reserve Act. See https://fraser.stlouisfed.org/files/docs/publications/books/fra_owen_1919.pdf at 43 - 44.

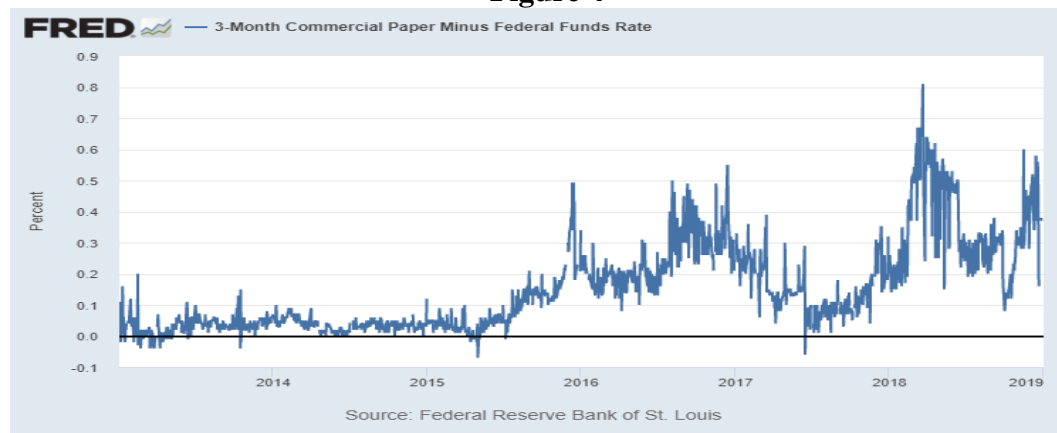
discount window is an essential near-real time tool for providing liquidity and preventing panic conditions; and that banking reforms that limit market-making in stressed conditions can be re-examined.⁹⁷ In Appendix B, we provide actions that banking regulators can take to mitigate the impact of bank reforms that have eroded liquidity in the US capital markets.

h. The SEC should not deviate from its statutory mandate because the Fed doesn't want to fulfill its own financial stability mandate

The SEC does not have a systemic risk mandate and the systemic risk arguments underscored by an alleged risk to taxpayers are demonstrably overstated by FSOC. The actions taken by the Fed have not entailed a cost to taxpayers. Indeed, the mandatory Fed filing before launching the March 2020 MMLF program clearly states that there was no expected cost to taxpayers.

There is clear evidence of widened spreads on commercial paper resulting from the 2014 reform, as shown in Figure 4. A further reduction to capital formation and efficiency can be expected if the proposed rule is implemented. After the effective date of the 2014 reforms, prime fund assets declined by approximately \$1 trillion as investors moved into government funds. The SEC should not further eviscerate its historic mission with damaging new reforms to 2a-7 funds on behalf of a flawed systemic risk argument that is conveyed in the form of falsehoods and platitudes.

Figure 4



⁹⁷ The Administrative Procedure Act requires a cost/benefit assessment of proposed regulations. The Fed appears to suggest that a "benefit" of ending prime MMFs would be to reduce the Fed's need to fulfill its statutory mandate to provide liquidity in the secondary CP markets in a financial crisis. There are several problems with that. First, eliminating MMFs will not reduce the need for the Fed to provide liquidity in the CP markets in a crisis or the size of that need. This need existed for many decades before the invention of MMFs, was shown in 2020 not to have been in any way reduced by the massive drawback after 2016 of MMFs as participants in the CP market, and will continue unabated if MMFs cease to exist. Second, the government incurred no losses on either the 2008 Treasury Guarantee program or the MMLF, but instead made a large profit in both cases. These facts also demonstrate that prime MMFs did not create or amplify systemic risk in March 2020, but instead that the money markets as a whole (meaning the markets for the underlying credit instruments themselves) are subject to periodic liquidity issues of the sort the Fed was established in 1913 to address by injecting liquidity into those markets through credit-worthy borrowers on secured terms. It should also be noted that an associated cost of achieving the alleged benefit of ending prime MMFs could be an unreasonable interference with the SEC's own statutory mandate and a potentially damaging precedent.

Appendix B

1. The DFA-Defined Term “Liquidity Event”

Section 1105 of the Dodd Frank Act defines the term “Liquidity Event”:

DFA Section 1105 (g)(3): LIQUIDITY EVENT. – the term “liquidity event” means – (A) an exceptional and broad reduction in the general ability of financial market participants— (i) to sell financial assets without an unusual and significant discount; or (ii) to borrow using financial assets as collateral without an unusual and significant increase in margin; or (B) an unusual and significant reduction in the ability of financial market participants to obtain unsecured credit.⁹⁸

Section 1105 identifies the circumstances and requirements under which the Fed may guarantee the obligations of solvent member banks, including that a Liquidity Event has occurred. However, it is quite clear that this definition can apply to financial crises generally; and that the March 2020 financial crisis was a “Liquidity Event” by this definition. It is understandable that the Fed would not want to employ this term if the actions to be taken did not fall under Section 1105 and it believed that confusion could therefore ensue; however, the timely use of this term, or an equivalent term, would be highly useful for alerting the banking system to engage in the activities such as the Fed prompted with its March 15th, 2020 measures; or modified or additional measures to be determined by the Fed.

2. Making The March 15, 2020 Amendments And Guidance For Use Of The Discount Window Permanent

Financial stability now stands alongside maximum employment and stable prices as a primary policy objective. In fact, maintaining market liquidity is a prerequisite to financial stability, and thus a core mandate of the Fed, even if past events suggest that it does specifically recognize it as such. Indeed, broad illiquidity in markets is itself the trigger by which systemic risk imposes damaging consequences; and it may be possible for the Fed to do more to intervene at an earlier point in the cascade.

Moreover, except for significant threats to financial stability, by its actions, the Fed appears to take U.S. capital market liquidity for granted and does not acknowledge either a responsibility to promote it, or its own post-2008 reforms that have reduced it. What does this mean as a practical matter? The Fed arguably has more latitude, when appropriate, to intervene to ensure funding market liquidity. Contrary to Owen’s dictum of *preventing panics*⁹⁹, the historical records suggest that the Fed waits until emergency conditions exit before reacting using its now diluted FRA 13(3) powers. Indeed, the Liquidity Coverage Ratio requirement that banks have High Quality Liquid

⁹⁸ Pub. L. 111-203, 124 Stat. 1376 (2010).

⁹⁹ https://fraser.stlouisfed.org/files/docs/publications/books/fra_owen_1919.pdf at 43 - 44.

Assets (“HQLA”) to cover 30 days of stressed market outflows is calibrated to the Bank for International Settlements (“BIS”) assumption that it will take central banks, including the Fed, up to 30 days to react to crisis conditions.¹⁰⁰

We believe that the Fed has taken a significant step in this regard with the measure pertaining to the discount window announced on March 15th, 2020, which we repeat below:

Discount Window ... The Federal Reserve encourages depository institutions to turn to the discount window to help meet demands for credit from households and businesses at this time. In support of this goal, the Board today announced that it will lower the primary credit rate by 150 basis points to 0.25 percent, effective March 16, 2020. ... Providing liquidity in this way is one of the original purposes of the Federal Reserve System and other central banks around the world.

To further enhance the role of the discount window as a tool for banks in addressing potential funding pressures, the Board also today announced that depository institutions may borrow from the discount window for periods as long as 90 days, prepayable and renewable by the borrower on a daily basis. The Federal Reserve continues to accept the same broad range of collateral for discount window loans.¹⁰¹

In its release announcing this measure, the Fed indicated that it would remain in effect until the Board determined otherwise. We suggest that the Fed give consideration to making this measure permanent to institutionalize a more rapid response to emerging systemic illiquidity; and take additional measures to reduce the stigma associated with discount window borrowing.

In this context, the aforementioned timely designation of a Liquidity Event would be an *additional* tool and signal to spur banks to greater activity under this and related provisions. Moreover, we recommend that these measures be directed to money market liquidity generally and have broad based eligibility,¹⁰² with the goal of materially reducing the need for any ad hoc emergency facilities.

3. The Standing Bank Repo Facility

The Fed has now instituted a standing repo facility whereby banks could obtain short-term loans to fund US Treasury holdings. This can quickly improve liquidity in the Treasury market during stress periods and could provide a lower borrowing cost to banks than the discount window. We strongly endorse the repo facility and suggest that it be expanded to other low risk asset classes, such as high-quality short-term (“HQST”) paper generally. However, in order for such facility to be truly effective in crisis conditions, the recommended amendments to the Supplementary Leverage Ratio (“SLR”) referenced below (or similar amendments), would also be necessary.

¹⁰⁰ Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (Jan. 2013) available at <https://www.bis.org/publ/bcbs238.pdf>.

¹⁰¹ The Discount Window and Discount Rate, *supra* note 41.

¹⁰² As is contemplated in Section 1101 of the Dodd Frank Act for emergency lending programs and codified in Section 13(3) of the Federal Reserve Act, 12 U.S.C. 343(3).

4. Regulations Affecting Market-Making

We recommend that, working with Congress as necessary, federal agencies should undo the damage from the regulatory response to the financial crisis of 2008. Specifically, the market-making activities of banks and their affiliates have been sharply curtailed as an unintended consequence of the Volcker rule and the other regulations that cause banks to seek rather than provide liquidity in a crisis. As a very simple step, regulation should not discourage bank ownership of commercial paper having minimal credit risk. We suggest that the Fed give consideration to studying how the complex array of new bank regulations reduced market-making in March 2020; and evaluate means of reducing these constraints during a liquidity crisis, or designated Liquidity Event.

- ***Modify The Volcker Rule.*** Section 619 of the DFA provides that banks with a federal backstop and their control affiliates cannot engage in proprietary trading in most types of securities and derivatives. The complex and demanding compliance requirements are set forth in such detail so as to discourage and limit market-making generally and particularly the risk of a violation in stressed market conditions. The starting point for understanding why this might be the case is the requirement that dealers may only hold inventories, on a desk-by-desk basis, based on anticipated customer trading needs. Buying up large blocks of securities that are underpriced in a crisis as a result of fire sales is not an option under the Volcker Rule if the levels acquired cannot be shown to be necessary to meet anticipated customer needs or the preapproved trading limits of the institution, or where needed to meet the institution's own internal cash management needs. The Fed itself acknowledges the adverse impacts from this rule:

Overall, our results show that the Volcker Rule has had a real effect on dealer behavior, with significant effects only on those dealers affected by the Volcker Rule and not all bond dealers.”¹⁰³

At a minimum, the overly precise rules that are designed to remove every scintilla of potential proprietary trading should be replaced by principles-based regulation that uses overall market-based risk measures (value-at-risk, VaR) by asset class, while requiring that each individual trading desk not exceed a determined VaR multiple of allocated capital.

- ***Allow All High-Quality Paper With Minimal Credit Risk And Maturities Of 90 Days Or Less To Be Included HQLA, Including During Stressed Conditions.*** To enhance liquidity in the funding markets, banks should be allowed and encouraged to include HQST paper acquired through market-making as HQLA. Such paper is typically (already) included in HQLA eligible securities, but banks may be averse to the acquisition of potentially less liquid HQST during a crisis for inclusion in HQLA. We also suggest that, in order to facilitate market-making, banks be

¹⁰³ Jack Bao *et al.*, *The Volcker Rule and Market-Making in Times of Stress* (2016) available at <https://www.federalreserve.gov/econresdata/feds/2016/files/2016102pap.pdf>, at 30.

encouraged to access the discount window under the revised procedures enacted in January 2003,¹⁰⁴ and as was directed by the Fed on March 15th, 2020, with particular emphasis on HQST. This action is particularly recommended for HQST paper maturing in 7 days or less that may be temporarily illiquid due to market conditions.

- ***Consider Allowing Any Discount Window Or Standing Repo-Eligible Paper To Be Included In HQLA During Stressed Market Conditions Such As A Liquidity Event.*** During stressed market or crisis conditions, such action would greatly enhance the ability of banks to take onto their balance sheets temporarily illiquid assets. To be fully effective, the corresponding required amendments to the SLR would also be appropriate.
- ***Address The Adverse Impact Of The SLR Particularly In Low-Rate Environments*** On April 1, 2020, over two weeks after the March 15th action with respect to the discount window, and six weeks into the crisis, the Fed temporarily relaxed (for 1 year) the SLR by allowing bank holdings of U.S. Treasury securities and reserves held at the Fed to be excluded from the total assets, or the denominator of the SLR. Banks strongly suggested that this amendment be made permanent, but the Fed repealed it on March 31, 2021. This event underscores the fact that the SLR allows no risk weighting in the calculation of total assets, but that in a crisis, the Fed can determine that Treasuries and reserves held at the Fed can be given a zero weight, presumably because of their zero or de minimis risk.

We recommend that the Fed be more proactive in waiving restrictions on the inclusion of any assets that can serve as discount window collateral and that this determination be responsive to real time indications of stress or crisis, such as spread widening, primary dealer commentary, discount window or standing repo facility usage, which could trigger timely Liquidity Event designation.

- ***Conforming Amendments.*** Implement any conforming changes to other capital or liquidity requirements to give effect to these amendments, particularly if a Liquidity Event has been designated, so that market-making actions taken by banks are balance sheet neutral.

¹⁰⁴ <https://www.occ.treas.gov/news-issuances/bulletins/2003/bulletin-2003-36a.pdf>